VOLUME 14 • NUMBER 4
COMPLETE TABLE OF CONTENTS • PAGE 193
INDEX OF CURRENT CASES • PAGE 257
CUMULATIVE INDEX • PAGE 256

THE JOURNAL OF
Taxation

A NATIONAL JOURNAL OF CURRENT NEWS & COMMENT FOR PROFESSIONAL TAX MEN

Compensation or Dividend?

HOW THE IRS IS CURRENTLY HANDLING SALARIES AND FRINGE BENEFITS OF STOCKHOLDER EMPLOYEES

Nine reports from lawyers and accountants throughout the country commenting on and analyzing current IRS treatment of such payments

New Regulations provide rules for real estate limited partnerships 230

Milwaukee & Suburban: new concept of estimated deductions? 204

Ruling 60-227 clarifies income in respect of a decedent 214

Banks cooperate with IRS in tax examinations of customers 220

ABA rejects voluntary disclosure proposal 221

CA-9 in Turnbow says boot makes B reorganization impossible 222

Proposed 269 Regulations list transactions indicating tax evasion....227

Gift between declaration and record dates taxable to donor 237

Negligence penalty seen as new hazard in careless T&E reporting 242

Regulations include National Office technical advice 242

Rights to conferences on requested rulings clarified 243

Annuities offer tax advantages to employees of exempt institutions ..247

MAPI study sees tightening up on foreign-source income 252

Treasury report on foreign tax incentives and havens awaited 254

Congressional tax committees' new members appointed 254

April 1961

ALL TAX DECISIONS, COURT ACTIONS, REVENUE RULINGS ISSUED EACH MONTH ARE SUMMARIZED IN THE DEPARTMENT COVERING THE POINT AT ISSUE

A tax service tailored to your requirements!

Use BNA's TAX MANAGEMENT Portfolios for 45 days—without obligation

BNA's bi-weekly TAX MANAGEMENT Portfolios provide a corporate tax administration service *custom-tailored to your needs*—thanks to a unique subscription plan that permits you to choose the Portfolios that cover corporate tax topics of consequence to you.

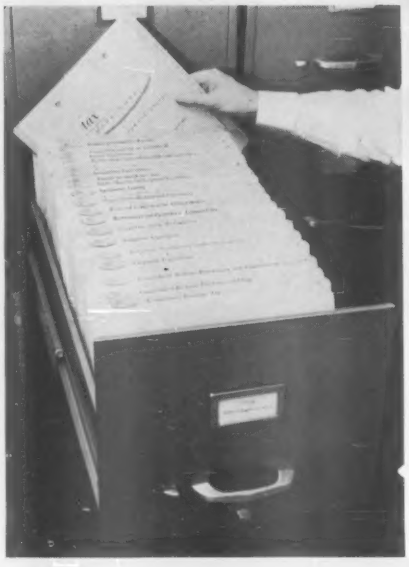
Portfolios contain comprehensive, topic-by-topic analyses of corporate income tax problems, including Tax-Pattern Outline, Detailed Analysis, Bibliography and References, and a complete set of Working Papers.

The Working Papers—perhaps the most valuable feature of the service—include graphic descriptions of problems; computation worksheets; prototype forms; specimen notices to shareholders, employees, customers, and suppliers; prototype submission documents to Internal Revenue Service (including sample requests for rulings); filled-in special tax return forms; accounting implementation documents (with explanations and comments); and similar materials.

Every Portfolio is kept up to date by means of change sheets or cover-to-cover revisions, whenever necessary. Portfolios are compact, convenient to use—fit any standard file drawer.

As part of the service, you also receive the bi-weekly TAX MANAGEMENT *Memorandum*, which offers the consensus recommendations on current corporate tax problems of an Advisory Board of active tax practitioners, attorneys, and accountants.

Select any seven of the TAX MANAGEMENT Portfolios listed below. Use them for 45 days, without obligation. If they do not give you the corporate tax help you require, return all materials—collect. Otherwise we'll bill you at the end of the 45-day approval period, at the Custom Service rates indicated below. (After your subscription is entered, you may request as many additional Portfolios as you desire at $14.50 per Portfolio per subscription year.)



Use this form to request TAX MANAGEMENT for 45 days

THE BUREAU OF NATIONAL AFFAIRS, INC.
1231 24th Street, N.W., Washington 7, D. C.

BNA

Please send me TAX MANAGEMENT on an introductory get-acquainted basis for 45 days, without obligation. I have checked below the seven Portfolios I wish to receive immediately, under your Custom Service Plan. I understand that I may return all materials, collect, within 45 days. Otherwise you may bill me after 45 days at the rates indicated.

(Select any seven Portfolios from those listed below)

(Numbers in parentheses are the serial numbers of the Portfolios.)

- ☐ Accrual of State, Local and Federal Taxes (24)
- ☐ Accumulated Earnings Tax (35)
- ☐ Bad Debts (19)
- ☐ Citizens Working Abroad for U. S. Employers (13)
- ☐ Consolidated Returns—Elections and Filings (21)
- ☐ Consolidated Returns: Preparation and Computations (Part I—Unconsolidated Items) (38)
- ☐ Consolidated Returns: Preparation and Computations (Part II—Consolidated Items) (38A)
- ☐ Consolidated Returns—Special Taxes and Taxpayers (43)
- ☐ Corporate Acquisitions (8)
- ☐ Corporate Liquidation under Section 337 (18)
- ☐ Corporate Liquidations under Section 333 (58)
- ☐ Corporate Recapitalizations (52)
- ☐ Corporate Separations (2)
- ☐ Corporate Stock Redemption (17)
- ☐ Declarations and Payments of Estimated Tax (1)
- ☐ Deferred Compensation Arrangements (20)
- ☐ Depreciation (6)
- ☐ Earnings and Profits—Dividends (32)
- ☐ Equipment Leasing (12)
- ☐ Establishing U. S. Business Operations in Canada (45)
- ☐ Estate Planning for Corporate Executives (11)
- ☐ Foreign Income—Export Sales (5)
- ☐ Foreign Operations under Sections 367 and 1491 (57)
- ☐ Involuntary Conversions (33)
- ☐ Licensing and Technical Assistance Abroad (44)
- ☐ Liquidation of Corporate Subsidiaries (16)
- ☐ Moving Expenses (3)
- ☐ Net Operating Losses (9)
- ☐ Net Operating Losses—Acquisitions of Loss Corporations (27)
- ☐ Partial Liquidation (37)
- ☐ Preparation and Use of Schedule M (31)
- ☐ Sales and Leasebacks (36)
- ☐ Sickness and Disability Benefits (4)
- ☐ State Taxation—Income Taxes (10)
- ☐ Stock Options (7)
- ☐ Tax Effects of Intercorporate Transactions (22)
- ☐ Transfers to Controlled Corporations (54)
- ☐ Travel and Entertainment Expenses (26—2nd)
- ☐ Western Hemisphere Trade Corporation (30)

Subscription Rates

Under the Custom Service Plan, subscription rates start at $144 per year for seven Portfolios (plus 26 issues of the bi-weekly TAX MANAGEMENT *Memorandum*) and increase by $14.50 for each Portfolio subscribed for beyond seven. Thus, if you subscribe for eight Portfolios, the subscription rate is $158.50 per year; or nine Portfolios, $173 per year; for ten Portfolios, $187.50 per year; and so on. All Portfolios are kept up to date by means of change sheets or complete, cover-to-cover revisions during the subscription year. You may exchange up to seven Portfolios for up to seven other Portfolios on different tax subjects, without charge, during the subscription year.

NAME_____

ORGANIZATION_____

ADDRESS_____

CITY_____ ZONE_____ STATE_____

Signed_____

575

$18 PER YEAR • $1.50 PER COPY
APRIL 1961 • VOL. 14 • NO. 4

JOURNAL OF *Taxation*

THE JOURNAL OF TAXATION is published monthly by The Journal of Taxation, Inc. Publication office, 320 North Sixth Street, Paterson 2, New Jersey; editorial office, 147 East 50th Street, New York 22. Telephone PLaza 3-8258. Material for publication is welcomed, either technical manuscripts or news items of interest to professional tax men. While the utmost care will be given material submitted, we cannot accept responsibility for unsolicited manuscripts.
© Copyright, 1961, by The Journal of Taxation, Inc. Application pending for re-entry at Paterson, N. J., March 13, 1956.

EDITOR
WILLIAM S. PAPWORTH

TECHNICAL EDITOR
ELEANOR MCCORMICK, LL.B., CPA
STANLEY W. HERZFELD, LL.B., Contributing Editor

NEW DECISIONS EDITORS
THEODORE BERGER, LL.B., CPA, Chicago
S. A. DYCKMAN, LL.B., CPA, New York
J. J. FRENCH, JR., LL.B., Dallas
HYMAN GORENBERG, LL.B., CPA, New York
STANLEY HAGENDORF, LL.B., New York
JOEL E. MILLER LL.B., New York

DEPARTMENTAL EDITORS
JOHN P. ALLISON, LL.B., MARSHALL, BRATTER GREENE, ALLISON & TUCKER, New York
PAUL E. ANDERSON, J.D., KENT AND BROOKS, San Francisco, Calif.
ALLAN BAKST, LL.B., CPA, New York
HARRY GRAHAM BALTER, LL.B., Los Angeles
THEODORE BERGER, LL.B., CPA, Chicago
CHARLES J. BUSICK, CPA, THE ANACONDA CO., New York
JOHN COSTELLOE, LL.B., CHADBOURNE, PARKE, WHITESIDE & WOLFF, New York
PETER G. DIRR, *Vice President*, MCKESSON & ROBBINS, INC., New York
CARL M. ESENOFF, CPA, EVERTS AND ESENOFF, San Diego, Calif.
MORRIS FRIEDMAN, LL.M., New York
RICHARD L. GREENE, LL.B., WHYTE, HIRSCHBOECK, MINAHAN, HARDING & HARLAND, Milwaukee
JAMES O. HEWITT, LL.B., CPA, LUCE, FORWARD, HAMILTON & SCRIPPS, San Diego, Calif.
BURTON W. KANTER, J.D., Chicago
CHARLES W. LAMDEN, CPA, EVERTS AND ESENOFF, San Diego, Calif.
MARTIN LORE, LL.B., CPA, New York
CHARLES S. LOWRIMORE, SR., CPA, C. S. LOWRIMORE & CO., Wilmington, N. C.
JACK R. MILLER, LL.B., Sioux City, Iowa
HAROLD OELBAUM, LL.M., *Asst. to General Tax Counsel*, RAYTHEON CO., Waltham
SIDNEY I. ROBERTS, LL.B., CPA, ROBERTS & HOLLAND, New York
J. P. STAPCHINSKAS, *Manager*, STATE & LOCAL TAXATION, FORD MOTOR CO., Dearborn
WILLIAM K. STEVENS, LL.B., *Assistant Vice President*, FIRST NATIONAL BANK, Chicago
GODFREY WM. WELSCH, CPA, LYBRAND, ROSS BROS. & MONTGOMERY, Dallas
JOHN WILCOX, LL.B., CHADBOURNE, PARKE, WHITESIDE & WOLFF, New York

EDITORIAL ADVISORY BOARD
MICHAEL D. BACHRACH, CPA, BACHRACH, SANDERBECK & CO., Pittsburgh
CHARLES MELVOIN, CPA, ALTSCHULER, MELVOIN & GLASSER, Chicago
ROBERT M. MUSSELMAN, LL.B., CPA, Charlottesville, Va.
MAURICE E. PELOUBET, CPA, POGSON, PELOUBET & CO., New York
JAY A. ROBINSON, CPA, ROBINSON & PETTIE, San Pedro, Calif.
PAUL D. SEGHERS, LL.B., CPA, SEGHERS, REINHART & MCCALL, New York

April Contents

REGULAR DEPARTMENTS

Accounting • 204

204 Milwaukee & Suburban decision may lead to new concept of estimated expense deductions, *by Thomas J. Donnelly, Jr.*
207 CLE's books on taxes are best sellers
207 New accounting decisions this month

Corporations • 222

222 CA-9 says boot makes B reorganization impossible; Turnbow conflicts with CA-7, *by Burton W. Kanter*
227 Proposed 269 Regulations list transactions indicating tax evasion
228 New corporate decisions this month

Estates, trusts & gifts • 214

214 Ruling 60-227 clarifies income in respect of a decedent arising from property, *by William P. Sutter*
218 New estate & gift decisions this month
219 New decisions: income taxation of trusts

Foreign • 252

252 MAPI study sees Congress and Treasury tightening up on foreign-source income
254 Treasury report on foreign tax incentives and havens awaited
254 Congressional tax committees' new members appointed

Fraud & negligence • 220

220 Banks ordinarily cooperate with IRS in tax examinations of customers, *by Leonard Bailin*
221 ABA rejects voluntary disclosure proposal
221 New fraud and negligence decisions

Partnerships • 230

230 New Regulations provide workable rules for real estate limited partnerships, *by Sidney I. Roberts & Herbert H. Alpert*
235 Analysis of new mining Regulations available
236 New partnership decisions this month

Personal • 237

237 Gift between declaration and record dates makes dividends taxable to donor, *by Harold Oelbaum*
238 New decisions affecting individuals

Procedures • 242

242 Negligence penalty seen as new hazard in careless T&E reporting
242 Regulations include National Office technical advice
243 Rights to conferences on requested rulings clarified
243 New procedural decisions this month

Shop talk • 255

255 Taxpayer challenges use of gift tax valuation table
255 Subchapter-S shareholder is not both old and new

Symposium • 194

194 Compensation or dividend? How the IRS is currently handling salaries and fringe benefits of stockholder-executives
195 Don't forget that past services can justify a high salary now, *by Warren C. Scieroe*
196 What is disallowed salary—dividend, gift, or simply nondeductible expense? *by Richard D. Hobbet & J. Bruce Donaldson*
197 IRS and taxpayers both find it hard to get evidence of comparable salaries, *by Harold H. Hart*
197 IRS compromising salary cases by threat of pension contribution disallowance, *by Lester M. Ponder*
198 Taxpayer's best policy is to fight an unreasonable salary disallowance, *by Louis L. Meldman*
199 Home entertainment and other fringes the IRS is very strict about, *by Andrew Kopperud*
200 When T&E is disallowed to the corporation, what happens then to the employee? *by Everett C. Johnson*
201 Some IRS districts are very active in contesting salary, T&E, and surplus, *by Joseph E. Tansill*
202 Valuing noncash fringes: care and ingenuity reward the taxpayer, *by Thomas J. Donnelly, Jr.*

Tax-exempt institutions • 247

247 Annuities offer unique tax advantages to employees of exempt institutions, *by Henry P. Green*
250 New decisions affecting tax-exempt institutions

Other new decisions

213 Miscellaneous new decisions this month
236 New state & local decisions
246 New compensation decisions this month
254 New decisions affecting special industries

Cumulative index • 256

Index to new decisions • 257

Authors in this issue

230 Herbert H. Alpert
220 Leonard Bailin
196 J. Bruce Donaldson
202 Thomas J. Donnelly, Jr.
204 Thomas J. Donnelly, Jr.
247 Henry P. Green
197 Harold H. Hart
196 Richard D. Hobbet
200 Everett C. Johnson
222 Burton W. Kanter
199 Andrew Kopperud
198 Louis L. Meldman
237 Harold Oelbaum
197 Lester M. Ponder
230 Sidney I. Roberts
195 Warren C. Scieroe
214 William P. Sutter
201 Joseph E. Tansill

Compensation or Dividend?

HOW THE IRS IS CURRENTLY HANDLING SALARIES AND FRINGE BENEFITS OF STOCKHOLDER-EXECUTIVES

ARRANGED AND EDITED BY RICHARD L. GREENE

In the nine reports that appear below, tax lawyers and accountants in various cities tell of their own experiences with the IRS in cases involving reasonable compensation, disallowance of expenses, and dividend treatment to executive-stockholders. Two conclusions stand out, both fundamentally disturbing: ☆ ☆ ☆ (1) The administrative power of the Revenue Agent to make adjustment to executive salaries is indeed vast, since it is limited only by the vague and undefined statutory test of "reasonableness." Correspondingly, the statutory and administrative framework place a great burden and responsibility upon the Agent to avoid arbitrary abuse of the power. He must overcome the considerable psychological handicap of being underpaid himself, plus the normal lack of requisite knowledge of the worth of an executive in a particular industry and in a particular company with all of its diverse operating problems. He must be fair and apply good judgment, perhaps even contrary to his basic instincts. ☆ ☆ ☆ (2) An unfortunate geographical disparity has apparently developed in the administration of reasonable salary and fringe-benefit tax problems. The result in a given case may depend on the location of the corporation and of the Internal Revenue Service office conducting the tax examination. Great variations of attitude and policy, severity or strictness, liberality, fairness, etc., seem to occur with surprising regularity. It is easy to say that what is a reasonable salary for a given job in St. Louis is obviously likewise reasonable in Los Angeles, Chicago, etc., and that there should be objective and uniform standards that will apply on a nation-wide basis. No such standards or uniform policies have yet been devised. Meanwhile, tax men can earnestly propose that IRS conferees, co-ordinators, and Audit Division heads throughout the country interchange views and at least work out some uniform guide lines, which they can pass on to their Agents, together with some words of wisdom to prevent abuse of the Agent's vast statutory power to probe into the reasonableness of the officer's compensation. Tax practitioners can serve their clients and aid other taxpayers by discouraging the occasional abuses by taxpayers that occur in the field of excessive salaries and improper fringe benefits. They can also help by being willing to litigate unreasonable demands by the Service.

IN THIS ISSUE THE JOURNAL presents a symposium-survey on the major questions arising from the compensation and fringe benefits of the stockholder-executive and the tax impact of disallowance of such deductions. The symposium was designed to supply some of the practical answers to the significant current problems facing closely held corporations, their executives, and their tax men. It proceeds on the premise that most of the usable knowledge and useful information in this contentious area will be found, not in text books or in a learned treatise, but in actual experience and judgment of leading practicing attorneys and accountants. We have, therefore, enticed tax men from diverse areas of our country to share with us some of their intriguing experiences and to lend to other tax men the benefits of their sage counsel.

We are delighted to introduce with this symposium a new writer to THE JOURNAL readers: *Warren C. Seieroe* of Chicago was until recently Special Attorney for the Internal Revenue Service. Mr. Seieroe stresses a vital factor often overlooked in reasonable salary cases—the role of past under-compensated services. We vigorously concur in his practical and useful suggestion that well-developed evidence on this point may aid in defeating an excessive salary-dividend assertion.

Readers will remember and welcome back the team of *Richard D. Hobbet* of Milwaukee and *J. Bruce Donaldson* of Detroit, who comment on the significant problems of whether "excessive" salaries can be treated by the executive-shareholder as gifts or as dividends for dividend credit purposes. *Harold H. Hart* of Salt Lake City furnishes some very informative sidelights on IRS attitudes and policics, particularly in his area.

Lester M. Ponder of Indianapolis, who has written for THE JOURNAL many times, vigorously notes an unpleasant and often abusive practice of some Agents to disallow pension-plan contributions by claiming the total of the compensation and fringe benefit is unreasonable.

Louis L. Meldman gives us some actual case studies involving salary dis-

allowance, which are graphic illustrations of the problems presented and their effective solution by way of settlement.

Andrew Kopperud of San Francisco warns of the danger areas on fringe benefits and sadly observes that abuses by some have created a great burden on the taxpayers seeking to substantiate proper deductions. *E. C. Johnson* and *Joseph Tansill,* leading Chicago CPA's, furnish some revealing experiences on "fringe dividends" and an insight into the attitude of Agents in their area. *Thomas J. Donnelly* of Milwaukee supplies a useful and practical technique for restricting and reducing the tax bite on "fringe-dividends."

Don't forget that past services can justify a high salary now

by **WARREN C. SEIEROE**

REASONABLENESS OF SALARY in any particular context is always difficult to ascertain, and certainly there is no rule of thumb or formula that can be applied to all cases. Few are the court opinions that get beyond the first several paragraphs without observing that the issue is purely factual and one to be determined on the basis of all of the factors and circumstances disclosed in the particular record.

In many cases salaries paid can be justified on the basis of services currently rendered. If such salaries are roughly comparable to those paid by other businesses for similar services, a dispute should not arise, and if it does, no serious problem should be encountered in establishing reasonableness. Comparability is the test suggested by Regs. Section 1.162-7 and is a favorite of the courts. Many situations, however, are not adaptable to this approach simply because the salaries paid are substantially greater than salaries paid by others for comparable services currently rendered. This does not mean that any part of such salaries necessarily should be disallowed as being unreasonable. If proper attention is given to the history of the corporation and the employee, they may be allowed.

In the case of new, or at least first-generation, businesses, it frequently happens that the officer's compensation will tend to parallel to some degree the financial success of the business. As the business matures and prospers, the stockholder-officer's compensation ascends. Finally, after some years the point is reached where a Revenue Agent determines the current compensation to be unreasonable. Seldom does the Agent of his own accord look back over the history of the business and the past compensation to determine whether the over-all compensation is reasonable or unreasonable. Decided cases indicate that all too frequently taxpayers also overlook the past in such cases. And yet the past often holds the key to the reasonableness of current compensation. The relatively few cases where taxpayers have bothered to produce evidence showing inadequacy of past compensation have produced remarkable success in this area.

In a typical situation a closely held corporate business started with a minimum of capital. Even if the venture achieves an early success, the stockholders are probably more inclined initially to retire debts, build up capital, and expand facilities than they are to remunerate themselves very substantially and thereby drain off the funds needed by the business. If business success comes only gradually and after prolonged struggle and development, the stockholder-employee is probably poorly compensated in the formative years more by necessity than by choice. Later, when profits and financial condition permit, his salary is brought into line with the true worth of his current services and maybe somewhat higher.

In such cases it is not unlikely that the greatest sacrifices were made and the most valuable services rendered during the corporate infancy, when the compensation was the lowest. When, in such a case, the stockholder-employee's compensation is challenged at some later stage as being in excess of the value of the services he currently renders, it is a costly oversight not to delve back into the years of slim salaries to find the reasonableness the statute requires. There is no requirement that compensation be equated with current services.

That past services in the proper circumstances will justify deductibility of current compensation has been settled since *Lucas* v. *Ox Fibre Brush Company,*[1] and this is true irrespective of the accounting method used by the employer. In effect, then, the question of adequacy of compensation is one to be determined on the basis of all factors, starting from the beginning of the employment. If the over-all compensation is reasonable in the light of the over-all services, there should be no disallowance because of variations in particular years.

Thus, compensation will be deductible in proper circumstances when continued after employment has ceased,[2] during prolonged periods of incapacitation,[3] or during periods of sharply reduced services or semi-retirement.[4] In these situations, deductibility clearly rests on past services. The same rationale is equally applicable where the challenged compensation is paid during periods of full-time employment. Where past services were inadequately compensated, that factor might well swing the balance where the current compensation is excessive[5] or where a lump sum is paid.[6] Furthermore, it is not necessary that the employer make any allocation as to the portion of current compensation considered applicable to current services and that applicable to past services.[7] In fact, it is probably undesirable to even mention past services in the minutes during the period of active employment, since the reference would carry a tacit admission that current compensation exceeds the current services.

Over what period the past compensation argument can be used effectively will, of course, depend on the particular facts spanning the entire period of employment, especially the degree to which past services were under-compensated. Successful use of the argument in one year or group of years would not necessarily preclude raising the same argument later, although eventually the point must be reached when all vitality

[*Warren C. Seieroe is a member of the Chicago law firm of McDermott, Will & Emery.*]

[1] 281 U.S. 115 (1930).
[2] *Mobile Bar Pilots Association,* 35 BTA 12 (1936).
[3] *Perel and Lowenstein, Inc.,* 14 TCM 412 (1955), *aff'd per curiam,* 237 F.2d 908, CA-6, 1956.
[4] *General Smelting Company,* 4 TC 313 (1944).
[5] *Rust-Oleum* v. *Sauber,* 58-1 USTC ¶ 9258, ND, Ill., 1958.
[6] *Indialantic Inc.,* 216 F.2d 203, CA-6, 1954; *General Spring Corporation,* 12 TCM 847 (1953).
[7] *General Smelting Corporation,* see note 4.
[8] *Cf. Sunnen,* 333 U.S. 591 (1948).

would be lost. Where, however, the argument is presented and decided adversely on trial, the decision would undoubtedly be collateral estoppel to consideration of the same past services in connection with a later year's salary.[8]

If, instead of a court decision intervening, there has been a partial disallowance of claimed salary deductions in a prior audit and an 870 agreement signed by the taxpayer, there would seem to be no bar to raising the past services argument in a later year. This would be especially true if the earlier settlement had involved a number of issues, all of which were disposed of in an over-all settlement, or if the past compensation question had not been considered. However, as a practical matter, an earlier settlement involving a concession by the taxpayer on a salary issue will likely prejudice administrative consideration of the past services argument for any later year. Even though the concession may have been justified only because of other mutual concessions on other issues, the attitude would likely be that the compensation slate had been wiped clean by the earlier agreement. ☆

What is disallowed salary – dividend, gift, or simply nondeductible expense?

by **RICHARD D. HOBBET & J. BRUCE DONALDSON**

DISALLOWED SALARY cases, by their very nature, almost invariably arise in related-taxpayer situations. A corporation pays its own stockholder a generous salary. A partnership or proprietorship nepotistically rewards the stumbling, but eager, efforts of the owner's son.

In the corporate situation it is not unusual to hear a Revenue Agent give as a reason for disallowance that the alleged salary is in part simply a distribution of profits.

And indeed it does have this characteristic. The determination is based on the fact that the services rendered do not represent adequate consideration for the salary paid. Therefore, presumably, the payment must have been made to the stockholder for some other reason. At this point it is arguable that Section 316 of the Code defines this as a dividend. It is a distribution of property[1] out of earnings and profits (assuming their existence) and it is without consideration.

The significance of such a conclusion, of course, is in the allowance of the dividend-received credit[2] for the stockholder, slight comfort though it may be.

The answer to this, which we have encountered in the Detroit and Milwaukee offices of the Service, is that the payment has not been made without consideration. It has been made without *adequate* consideration. Furthermore, if it is a distribution, it is not a distribution with respect to the corporation's stock as provided in Section 301. It does little good to argue earnestly that this approach is inconsistent with the Commissioner's treatment of bargain purchases in his Regs. Section 1.301-1(j), where he suggests that a stockholder has received a dividend if property of the corporation is transferred to him for an amount less than its fair market value. Isn't that what is done in an excessive-salary situation? Cash is distributed to the employee for services that have a fair market value less than the cash received.

Nor has it helped us much to point to Regs. Section 1.162-8, where the Commissioner states:

"The income tax liability of the recipient in respect of an amount ostensibly paid to him as compensation, but not allowed to be deducted as such by the payor, will depend upon the circumstances of each case. Thus, in the case of excessive payments by corporations, if such payments correspond or bear a close relationship to stockholdings, and are found to be a distribution of earnings or profits, the excessive payments will be treated as a dividend."

In spite of this express authorization for dividend treatment, we have encountered no success in obtaining the dividend credit in unreasonable-salary cases. And this adamancy finds support in some old cases, namely, *Brauer* (6 BTA 579 (1927)), *Bone* (46 F.2d 1010, MD Ga., 1931), and *Austin* (24 F.2d 844, ND Ga., 1928). Basically the courts take the position in these cases that the payments are compensatory in nature, though not deductible by the corporation.

A case of the Second Circuit Court of Appeals gives some support for the contrary position.[3] Unfortunately, it is not a square holding on this point, as the stockholder had failed to pay his tax under protest. The court held that this barred recovery in a suit against the collector. In an aside, it bewailed the injustice of the result and stated that, but for this bar, the suit would have succeeded and the excessive salary would have been treated as a dividend.

The stakes are somewhat higher when the claim is that the excessive compensation was in fact a gift, nontaxable in the hands of the recipient. If this claim is successful, the parties involved will certainly be less resentful of the disallowed salary. But it is a difficult position to maintain.

The employer has claimed it to be a salary and has filed no gift tax return. He will be reluctant, to say the least, to expose himself to an income tax fraud case by asserting that he intended the payment as a gift and then deducted it as salary. The employee will undoubtedly have reported it as taxable income, so he must take a position inconsistent, not simply in law but in the operative facts, to the position taken on his tax return.

These factors posed an insurmountable object for the taxpayer in two cases dealing with this issue, *Smith* v. *Manning* (189 F.2d 345, CA-3, 1951) and *Wood* (6 TC 930 (1946)). In neither of these cases was evidence offered that the payments were made with donative intent, and this failure was determinative of the issue.

In the *Wood* case, the Tax Court discussed two earlier cases[4] in which salaries had been disallowed, the court saying that the unreasonable payments could be "regarded as gifts." The Tax Court brushed the statements aside as dicta.

It seems unlikely that a taxpayer could prevail in this claim without testimony of the employer-donor that he intended to make a gift. This is going to be unavailable in most cases.

[*Richard D. Hobbet is associated with the Milwaukee law firm of Michael, Spohn, Best & Friedrich. J. Bruce Donaldson is a member of the Detroit law firm of Raymond, Chirco, Fletcher, Cohan & Donaldson.*]

[1] As defined in Section 318, IRC.
[2] Section 34, IRC.
[3] *Winant* v. *Gardner*, 29 F.2d 836 (CA-2, 1928).
[4] *Rottenberg*, 20 BTA 589 (1930), and *Wright*, 1 BTA 1337 (1929).

We have encountered the related issue in another corporate situation. Occasionally the unreasonable accumulation of surplus issue is combined with an unreasonable salary disallowance. We have argued that, if salary is disallowed, the corporation should be given credit for having paid a dividend, both in determining the accumulation of surplus to which the surtax would apply and as evidence that the corporation has been paying dividends. Surprisingly, when compared with the reaction of the Service to the dividend-credit claim, this argument has been accepted, on occasion, by Revenue Agents.

In any event, the cases are mostly against this related adjustment, and unless it can be obtained in an over-all settlement, it is doubtful that taxpayers will have much success in courts on these issues. ☆

IRS and taxpayers both find it hard to get evidence of comparable salaries

by **HAROLD H. HART**

WHEN THE EMPLOYEES of a corporation acquire its stock and become its owner-managers, they may not realize it but they are also acquiring a reasonable-compensation problem. Salaries paid them in prior years will be compared wtih salaries after the change in ownership, and the Government representatives will be reluctant, indeed, to allow substantially increased compensation after the acquisition. In support of increased salaries, the owner-managers must point to increased responsibilities in undertaking complete management of the corporate affairs and to increased sales and profit ratios. The new owners, however, are at a disadvantage because the full fruits of their management probably will not appear for several years after the date of acquisition of the corporation.

The executive whose salary is challenged often presents bona fide offers of employment by others, offering compensation equal to or in excess of the salary challenged. The Service, however, is not greatly impressed by offers made by distant potential employers. It is reasoned that salaries paid in Chicago, New York, Los Angeles, or San Farncisco are known to be on a higher level than salaries paid for comparable work in Salt Lake City. Here we find that the Service is interested in offers made in our vicinity only. They are interested in the financial status of the offeror. If the company is larger than the taxpayer, the Service argues that, even though the questioned employee might be worth the proferred sum to the offeror, the employing corporation would not be justified in paying it in view of its smaller gross and net. The examining officers are not impressed with the contention that this reasoning discriminates against people in smaller cities. They say only that what is reasonable is measured by conditions in the place of employment.

On pure theory the most convincing evidence is compensation paid by like companies for like services. Many problems, however, arise in actually trying to use this test. It is often impossible to obtain a true comparison. For example, there are relatively few corporations doing business here in our intermountain area, and true comparisons are often unobtainable. Even when a true comparative can be found, the IRS is handicapped in presenting its evidence to the taxpayer. If the information is obtained from examination of Federal income tax returns, the taxpayer cannot be told the name of the concern or the salary paid to the employee doing like services. It is not very satisfactory to say, "We have knowledge of comparatives, but we cannot reveal the nature or source of our knowledge." Of course, if the case goes before a court, the Government must somehow show evidence of payments for similar services if it is to present a convincing case.

The taxpayer, on the other hand, also has problems in presenting this kind of evidence. The thinness of the business community often leaves few, if any, local concerns truly comparative. Competitors will guard carefully the facts about their gross and net income and salaries paid. Under such conditions the taxpayer cannot present any helpful evidence. And even if the companies are inclined to be cooperative, the taxpayers face another barrier, *i.e.*, the reluctance of competitors to give facts and figures they know will be presented before the Service. They are fearful that, if the evidence is presented to the Government, another examination will be ordered of their past returns and that their salaries will be questioned.

But, despite these difficulties, in practically all cases argued before the Service, much time in conferences is used in presenting and discussing amounts allegedly paid for like services by other concerns.

Of course, a corporation that distributes only small amounts to its stockholders as dividends is faced with a difficult task in justifying high salaries paid to stockholder-officers. If the salaries are very liberal and the net income is small, it is almost impossible to convince the Service that the salaries are allowable as deductions.

The Service, however, is anxious to reach a solution without litigation, and in the great majority of cases involving this question, some settlement is arrived at prior to court action. ☆

[*Harold H. Hart is a member of the Salt Lake City law firm of Richards, Bird and Hart.*]

IRS compromising salary cases by threat of pension contribution disallowance

by **LESTER M. PONDER**

DISALLOWANCE of all or a part of the contribution to the pension fund is currently being insisted on by the IRS when it considers an officer's compensation unreasonable. In recent cases it has been noted that the examining Agent will propose a disallowance of a substantial amount of the claimed deduction for officers' compensation and, if the taxpayer-corporation refuses to agree to the disallowance, the Agent will suggest disallowing a smaller portion of the deduction, based upon the amount of the contribution to the pension trust of the corporation.

If this suggestion is not agreed to and the taxpayer appeals the case to the Appellate Division, the same trend is

[*Lester M. Ponder is a member of Indianapolis law firm of Barnes, Hickam, Pantzer & Boyd.*]

noted in dealing with that office. The argument is usually made that the compensation directly paid to the officer is reasonable, but when added to the contribution to the pension trust in his behalf, it thereby becomes unreasonable in the exact amount of such contribution. This approach is an insidious method of disallowing the deduction for contribution to the pension trust for the officers whose compensations have been questioned.

Section 1.162-10(c) of the current Treasury Regulations provides that "For rules relating to the deduction of amounts paid to or under a stock bonus, pension, annuity, or profit-sharing plan or amounts paid or accrued under any other plan deferring the receipt of compensation, see section 404 and the regulations thereunder."

Section 1.404(b) of the Regulations provides that "In no case is a deduction allowable under section 404(a) for the amount of any contribution for the benefit of an employee in excess of the amount which, together with other deductions allowed for compensation for such employee's services, constitutes a reasonable allowance for compensation for the services actually rendered. What constitutes a reasonable allowance depends upon the facts in the particular case. Among the elements to be considered in determining this are the personal services actually rendered in prior years as well as the current year and all compensation and contributions paid to or for such employee in prior years as well as in the current year."

It is believed that in most cases the contributions to pension trusts for any individual employee are not sufficiently substantial to cause a serious question as to the reasonableness of the total compensation when the direct compensation is added to the pension-trust contribution. For example, pension-trust contributions seldom exceed $5,000 for the great majority of closely-held corporations. However, even in view of this insubstantial addition to directly paid compensation, the Internal Revenue Service apparently feels that it can nibble away at the concept of reasonableness of compensation by demanding that at least a portion of the contribution to the pension trust be considered excessive compensation.

When a pension trust is examined by the Service prior to the ruling as to its qualification, attention is usually given to the total amounts to be paid to the chief officers and stockholders of the particular corporation. Although it is realized that there is no ruling as to the reasonableness of the total compensation at the time of the ruling on the qualification of the plan, consideration is given to the total amount of corporate benefits to be received by the employee under both the direct compensation and the pension trust at that time in connection with the "discriminatory" investigation. To have the Service contend at some future time that the compensation is unreasonable by the amount of the pension-trust contribution is believed to be paradoxical and indefensible under basic rules of tax administration.

In most instances, the amounts of the pension trust contributions are not large enough to warrant extended litigation on the point by the corporate employer, and, hence, many corporate employers will feel that they would rather swallow the disallowance of the pension-trust contributions as being unreasonable compensation than litigate the question in court. Perhaps the Service has become aware of this tendency not to litigate such questions involving moderate amounts and has seized upon this method as a backdoor entrance to the disallowance of the pension-trust contributions previously approved by the Service for allowance when the plan was submitted for qualification ruling.

This trend by the Service will be halted only if taxpayers will stand firm and resist, by litigation if necessary. ☆

Taxpayer's best policy is to fight an unreasonable salary disallowance

by LOUIS L. MELDMAN

THE OUTCOME of a number of salary cases I have handled in the past few years convinces me that a taxpayer who rejects an arbitrary proposed disallowance of salary will find that his firmness and willingness to litigate will bring him a satisfactory solution. Of course, the best solution may not be to fight the case up through the IRS. Sometimes you can do much better by paying the deficiency and suing in district court.

Only recently I did this in a traditionally very difficult kind of salary case —compensation for the widow and daughter of the founder of a successful business. Upon audit for 1953 and 1954, the major change made by the Agent had been officers' salaries. The president, the widow of the founder of the company, had received $27,200, her daughter $24,000, and the general manager $18,000. The Revenue Agent allowed a salary of $12,000 for the founder's widow and $7,500 for the daughter. The founder had died about five years before, and the widow and daughter had successfully conducted this business with the able assistance of the general manager. The taxpayer was in the excess profits tax bracket but, nevertheless, agreed to the disallowance. Upon investigation, I felt that part of the disallowance was unwarranted. A claim for refund was filed, in which it was contended that the original salaries paid to the president (founder's widow) and half of the salaries paid to the vice-president (the daughter) were reasonable and should have been allowed. It was contended that the salaries represented proper payments in view of the duties, responsibilities, and work performed by these individuals. The claims were duly disallowed by the Service, and a complaint was filed in the United States district court. At the time of a pre-trial conference, the attorney for the Justice Department suggested a possible settlement. After further negotiations the officers' salaries were allowed at a figure half-way between the amount claimed for the years in question and the amount recommended by the Service. For the years 1953 and 1954 the president claimed $27,200, the Agent allowed $12,000, and the final settlement was $19,750. The vice-president claimed $12,000, the Agent allowed $7,500, and the settlement was $10,000.

The same corporation was again involved in salary disallowance for subsequent years, and the same amount was allowed for officers' salaries as in prior years, even though a pension plan was enacted in the later years that set aside a substantial sum for the officers. It is

my conclusion from this case that, if the taxpayer has a reasonable basis for instituting a suit in connection with a disallowance of salary, the attorneys handling the case for the Government in the district court would generally settle on a 50-50 basis.

Another case involved salaries paid to three brothers operating a manufacturing company. Each brother was taking a salary of $25,000. The Government suggested a salary of $10,000 for each, but the case was finally settled on the basis of a disallowance of a total of $5,000 for the three officers. In all probability if this case had been taken to the Tax Court it could have been won. The officers in this case were responsible for the invention of machinery that resulted in a considerable savings in the manufacture of the company's product.

One day I was asked to attend a meeting at a company's office by the corporate officers and a Revenue Agent. This corporation had been reporting net profit of approximately $21,000. The total officers' salaries were $88,000, of which $30,000 represented a year-end bonus. The Agent proposed to disallow this entire bonus. As a result of one afternoon's conference, the case was settled on the basis of a disallowance of $10,000 of this bonus. The corporation had paid no dividends, and the bonus was divided in accordance with stockholdings by the principal officers. During our discussion it was pointed out that these principal officers were actively engaged in sales and would have received the full amount of salaries had they been on a commission basis. Consideration was also given to services rendered in prior years for which they were not properly compensated. This settlement was made with the Revenue Agent and was approved.

A Revenue Agent proposed to disallow officers' salaries of a grocery supermarket. The supermarket had sales in excess of $1 million and was operated by three brothers. One of the brothers was a general manager, and the other brothers assisted him. The total officers' salaries paid in 1953 amounted to $80,000. The Agent disallowed $20,000. Total salaries paid in 1954 were $99,000. The Agent disallowed $9,000. This matter was taken up with the Group Chief. The Group Chief pointed out that salaries paid general managers of supermarkets by the chain stores were nowhere near the amount of salaries paid by this company. We pointed out that the manager in this case not only was in charge of the store but had charge of the purchases, financial policy, and advertising. Likewise, the other two brothers had similar duties. We also pointed out that these men were underpaid in prior years. In the final settlement two-thirds of the amount disallowed by the Agent was allowed.

I represented a small realty company where the Government disallowed excess salaries taken by the sole officer-stockholder. The Agent recommended disallowance of all salaries in excess of 5% of gross rental. He claimed that such a percentage represented the commission that an ordinary real estate broker would charge for management of rental property. We were able to increase the reasonable salary allowance to 15% on the theory that, in addition to collection of rent, the property required supervision of the premises, making of leases, and repair of the structure.

[*Louis L. Meldman practices law in Milwaukee.*]

I represented a painting company where five brothers were working together in the operation of the business. During the course of the year they received salaries payable on a weekly basis. They received no overtime, such as the workers under union contract were entitled to. At the end of the year they each received a large bonus. The Government disallowed this bonus. The case was taken before the Tax Court and settled before trial on a basis of about 60% of the amount originally claimed.

In all of these salary cases it is difficult to obtain comparable salaries in like industries because taxpayers are reluctant to get involved with the Service. Also, competitors are not always willing to testify on behalf of others in the industry. ☆

Home entertainment and other fringes the IRS is very strict about

by **ANDREW KOPPERUD**

I HAVE SEEN few audit problems as a result of medical plans, health and accident insurance, group term life insurance, split-dollar life insurance, qualified profit-sharing plans, pension plans, and restricted stock options. In addition, Agents appear sensible in regard to the amounts that constitute reasonable compensation. Therefore, these methods of compensating stockholder-executives have additional merit in that they do not raise questions upon an audit.

Conversely, you can expect audit adjustments in regard to travel expenses, automobile expenses, entertainment expenses, and any form of remuneration to or on behalf of wives or children of stockholder-executives.

The Internal Revenue Service takes the position that the disallowance to the corporation of the payment of any "fringe benefit" on behalf of the stockholder-executive in a closely held corporation is a dividend from the corporation and, accordingly, not deductible by the corporation. The argument that such payments are additional compensation is seldom accepted. The stockholder-executive is also charged with income in the amount of the disallowance. Accordingly, the tax bite can be more than 100% of the amount involved!

There are certain categories of expenses upon which no amount of evidence seems to be adequate substantiation.

1. For example, a stockholder-executive owns a yacht and charges the corporation only for the out-of-pocket expenses incurred when using the yacht for business purposes. The Service may be shown: (a) a log of the yacht, in which the customers, suppliers, and employees have signed their names and the dates they were present and (b) pictures of these individuals taken on the yacht; nevertheless, it may become apparent that the taxpayer will be ahead in aggregate dollars to concede *in toto* the deductions taken for the yacht and hold fast on other issues.

2. Similarly, Agents are biased toward business trips to or conventions at resort areas such as Hawaii, Palm Springs, or Lake Tahoe. The Agents have undoubtedly had experiences that entitle them to look at such expenses closely. However, it is often difficult to obtain a fair result in a legitimate situation.

3. The typical Agent also feels that it is impossible for wives or children of stockholder-executives to be properly in-

[*Andrew Kopperud, a member of the California bar, is associated with Cooley, Crowley, Gaither, Godward, Castro & Huddleson, San Francisco.*]

volved in the corporation's business. For example, one case arose where a large national corporation required the presence of only a few of the executives' wives at conventions expressly to obtain the good will of the customers and their wives. The wives were selected by the corporation, and all hands felt that it was a corporate matter. The wives actually performed substantial and arduous services on behalf of the corporation. They planned and supervised the entertainment. The corporation reimbursed the expenses of the wives, and the Service took the position that the expenses were income to the executives. The matter may be litigated.

4. The Service also has an eagle eye for the use of automobiles. The Service undoubtedly has sufficient reason to take a hard look at such expenditures. However, if the car involved is a convertible (and Agents ask), the taxpayer will have to fight for his deductions! The Service is regularly disallowing a portion of the expenses of a business auto as the cost of commuting. This position has resulted in some very fine distinctions as to whether the automobile is used en route from home to office, whether the executive is "on call," etc. It is my belief that the Agents use the commuting argument as a rough adjustment for other suspected personal uses. It is no longer true that a businessman owning two cars and using one in business will automatically be allowed deductions for all the expenses of one car.

5. Home entertainment is another area where substantiation is a Herculean task. The Agent may not allow the deduction even if you present all evidence conceivably available to any taxpayer.

A few years ago it might have been correct to state that the taxpayer who had no records would end up in a better dollar position than the taxpayer who had partial or incomplete records. There appears to be a substantial change in this area, and the taxpayer with few or no records is progressively finding it more difficult to obtain deductions for his ordinary and necessary business expenses.

Taxpayers who have abused these deductions are in great part responsible for the present status wherein the Agents are so conditioned in certain areas that the Service is sometimes not allowing proper deductions. ☆

When T&E is disallowed to the corporation, what happens then to the employee?

by **EVERETT C. JOHNSON**

[*Everett C. Johnson, CPA, is a partner in the national accounting firm of Arthur Andersen & Co. He is in charge of the tax department of its Chicago office.*]

WE ARE ALL AWARE of the current campaign of the Internal Revenue Service to disallow unsupported travel and entertainment expense and personal living expenses paid for officers and employees by corporate employers. Whenever an examining Agent proposes an adjustment in expenses of this type, a problem arises. If the expenditure is not supported by the employee, is it an improper deduction for the corporation or is it deductible by the corporation as compensation and taxable to the employee? In other words, is the expenditure compensation or a dividend? We can anticipate increasing problems in this area for some time to come and will undoubtedly see many court decisions.

It seems to me that except for the possibility of excessive compensation any payments to an employee who is *not* a substantial stockholder of the corporate employer or related to such a stockholder should be allowed as compensation to the corporation and taxed as such to the employee. However, in several instances recently examining Agents have contended that such payments are not intended to be compensation, are not reported on Form W-2, and therefore, cannot be so regarded. In addition, the contention has been made that to allow such amounts as compensation would encourage the continuance of classification of such payments as reimbursed expenses with the hope that they would not be discovered. It has been my experience that the Conference Coordinator's Conferees and the Appellate Division representatives often are willing to allow the payments as compensation provided that there is some semblance of support for them and that the compensation including such items is reasonable. However, such allowance is usually conceded only when the individual agrees to pay the additional tax resulting from the inclusion of the amounts as his income.

I will give below several examples of the type of items proposed for inclusion in individuals' incomes in recent examinations. The most aggressive examining Agents in this area are those in the office audit section. One such examiner told me that, in his opinion, no expense items were ever allowable unless completely documented and that there had to be additional tax payable by everyone who claimed such expenses on his return or was reimbursed for any sizable amount. Fortunately, this arbitrary, inconsiderate attitude does not prevail in the field or with the conferees.

One examining Agent in the office audit group proposed that an executive should include in his income payments received from the corporation for dinner allowances and hotel room charges where the executive worked late at night. This man lived in a distant suburb, and his effectiveness would be impaired if he worked late, commuted to the suburb, and returned to the office early the next morning. The proposed treatment of such payments as income seems improper and unsupportable. I intend to carry the argument as far as necessary to secure the allowance of the small deductions involved because these payments were incurred for corporate business purposes and do not result in any benefit to the employee. The individual involved is not a substantial stockholder nor is he related to a substantial stockholder.

In another situation, the examining officer proposed the inclusion in income of the value of a chauffeured car provided for a corporate officer. After many arguments about this proposal and other proposed adjustments, the entire case was settled by permitting the Agent to include in the officer's income $1,200 for the personal use of the car on nonbusiness matters. Another Agent examining the corporate return then proposed the disallowance to the corporation of this $1,200. After several discussions of this and other items, he agreed

that it was allowable. The officer was a stockholder owning a small percentage of the stock of the corporation, whose shares are listed on the New York Stock Exchange.

In both of the above instances, the proposed additional income to the officer is compensation. As compensation or as business expense, it is deductible by the corporation. We have been quite successful in holding the line on this theory where the individuals involved are not directly or indirectly substantial stockholders. Where substantial stockholders have been involved, such payments are frequently asserted to be dividends. [Sufficient supporting facts should defeat any such assertion.—*Ed.*]

In another case a corporate client maintains a suite of rooms in a hotel near its office. For personal reasons the chief executive chooses to live in a distant city and uses the suite as living quarters when he is at the office. He travels a great deal and spends only one or two days a week in town. When he is away, the suite is used by local sales people for meetings and entertainment of customers. Occasionally, when hotel rooms are difficult to obtain, the suite is used overnight by out-of-town sales people or customers. An examining Agent proposed the disallowance of the expense of the suite to the corporation and proposed taxing the entire cost to the chief executive as dividend income. The Appellate staff allowed the entire deduction to the corporation and computed the value of the executive's personal occupancy of the suite. This they taxed to him as compensation.

In another instance large sums were withdrawn by three officer-stockholders as reimbursement for unsupported entertainment and travel expense. When these were questioned, our insisting that such amounts, if not reimbursement of expenses, were deductible as compensation resulted in a peculiar settlement. After many discussions of the issue with the Service representatives, we reached a point where they insisted that the maximum amount allowable as expense was 50% of the total involved and that the 50% to be disallowed must be taxed as a dividend. The taxpayers were unhappy with this proposal but they were convinced that this proposal probably was as good as any result they might obtain if the case were tried in the Tax Court. However, the individuals were short of cash and did not want to agree to pay large sums personally. After several hours of additional discussion, the cases were settled by permitting the entire amount to be disallowed to the corporation, and no part of it was taxed to the individuals. This was accepted for settlement purposes only and did not constitute a precedent for that group for the future.

It has been my experience that the present drive of the Service against taxpayers claiming excessive deductions for expenses is having several results. After taxpayers have been subjected to the annoyance of a thorough examination or an office audit, where they often feel they are being insulted and harassed by arbitrary petty disallowances, they feel encouraged to claim larger deductions. The feeling that larger claims are in order comes from the impression that some of the amount claimed will be disallowed regardless of how it is substantiated and, therefore, the deduction of a larger amount should result in a proper allowance after examination. An individual cannot afford to spend his own time or to hire others to argue about proposed deficiencies of a few hundred dollars even though he feels the adjustments are not justified.

On the other hand, I have found that many of the examining officers in the field are willing to study the information the taxpayer has and to make a fair evaluation. They do not try to collect a $100 deficiency just because the taxpayer can't afford to fight it. However, in any case where an adjustment of importance is involved, it will be insisted on if the taxpayer cannot produce the evidence to sustain his position. The field examinations and public announcements of the Service are causing corporations to limit reimbursements for unsupported expenses to a minimum and are causing individuals to keep better and more accurate records. ☆

Some IRS districts are very active in contesting salary, T&E, and surplus

by JOSEPH E. TANSILL

ONE OF THE MORE SOBERING recent developments appears to be a resumption or step-up of the attack on the reasonableness of officers' compensation in closely held corporations. Three of these cases,[1] all of which involve machinery manufacturers in northern Indiana, have been through the Tax Court and are on appeal to the Seventh Circuit. They are characterized by a number of factors that have been regarded as favorable to taxpayers in the past but that did not here carry much weight with the Service or the Tax Court, such as the existence of a contingent bonus plan entered into in an earlier year, when there was little or no additional compensation; the competence of the individuals in question and their training and experience; the unusually long hours worked, and in each case the uncontroverted unique ability of the individuals, which apparently was directly responsible for the increased business. The Tax Court's short answer, that the increased business (and hence the increased compensation) was due to the Korean War, seems to miss the point that the taxpayer-corporations would not have gotten the business except for these individuals. A grim facet of at least one of the cases is that the deficiencies, if they stand, render the taxpayer insolvent, with possible transferee liability on these same individuals to the extent of the amounts of compensation deemed unreasonable.

A similar quickening of activity seems to be taking place in Code Section 531 assertions that an unreasonable accumulation of surplus has occurred. In this writer's experience, for years there was far more speculation than concrete activity under this provision, but it appears that renewed instructions to field Agents to make an affirmative determination about the applicability of Section 531 have resulted in many more disputes, including cases of relatively small corporations, where the retained earnings are barely above the statute-protected amount of $100,000.

The current emphasis on executive expense accounts and fringe benefits is well known and seems to be a prime subject of inquiry by Revenue Agents in all parts of the country, as might be expected. Even here, however, it does appear that some areas are subject to

[1] *Adams Tooling, Inc.*, 33 TC 65; *Ernest Holdeman & Collett*, 19 TCM 42; *Huckins Tool & Die, Inc.*, 18 TCM 856.

more stringent enforcement than others. Reports from one part of the country, for example, indicate that executives' club dues and expenses are generally unchallenged, while in another area, it seems to be routine for the examining Agent to assert that such expenses paid by the employer are not deductible to it and represent dividend income to the individual as long as he holds some stock in the employer corporation, and it may be only a nominal amount.

Expenses of wives of employees paid by the employer, in attending conventions or trade shows or in foreign travel, seem to constitute another area of spotty enforcement when various parts of the country are contrasted with each other. There are variations among Agents in the same district, of course, so that complete uniformity does not exist, but in general it appears that the Middle West has been more vigorous than some other areas on the question of expense account problems, including wives' expenses. Litigation may ultimately be required to settle these questions, where the wife's presence is a "command performance" dictated by an important customer or where the wife does in fact perform an important function in helping her husband to entertain customers or suppliers and their wives. Modern corporate philosophy regards a key employee's wife as an indispensable member of the team, and many a promising career has been blocked because the individual's wife doesn't measure up. Logically, the question of deductibility of wives' expenses is not restricted to out-of-town costs; it applies with equal force to in-town entertaining.

The deductibility of payments to persons whom the taxpayer refuses to identify has been disallowed in several cases. These cash payments, to labor racketeers and the like, may be morally indefensible but represent a fact of business life in some areas. In one case, involving a closely held corporation, the disallowed amount was taxed to the sole shareholder as a dividend. The alternative to accepting this treatment would have been to have the amount taxed to the employee who was the last identified person to handle the funds. The problem of the employer reimbursing that employee for such a deficiency (plus the additional tax on the reimbursement) was considered further complicated by the fear that the reimbursement would be held nondeductible as unreasonable compensation.

The use of company-owned recreational facilities (yachts, hunting lodges, resort accomodations, etc.) by stockholder-executives has been vigorously attacked as a nondeductible dividend to the individuals where the facilities are not made available to all employees. This was so in one case, even where the expense of other comparable facilities available to all other employees was accepted. On the other hand, the use of company-owned automobiles and airplanes does not seem to have acquired the same stigma, although this may change. It is interesting that questions relating to the use of automobiles and airplanes were not included on the various tax return forms for 1960 but do appear in the questionnaire (Form 2895) used by Revenue Agents in checking travel and entertainment expenses. ☆

[*Joseph E. Tansill, CPA, is a member of the firm of Lybrand, Ross Bros. & Montgomery and is tax partner for its Chicago office.*]

Valuing noncash fringes: care and ingenuity reward the taxpayer

by THOMAS J. DONNELLY, JR.

CORPORATIONS ARE OFTEN INGENIOUS in devising ways and means to permit their key employees to share in profits without, they hope, the impact of taxation. Expense accounts, automobiles, boats, and even residential or resort property are often made available to their favored sons as an alternative to other forms of compensation in which the Government will most certainly share. Where a corporation permits its employees to use corporate property for their own pleasure gratis or for a nominal consideration or where it improves property owned by them, there is unquestionably a tax to be paid by the recipient, and the amount of income on which this tax must be paid is sometimes difficult to forecast.

The corporation will get a deduction for passing on these benefits only if it is able to demonstrate that expenditures for them are authorized and actually constitute reasonable compensation for services or that the expense is otherwise necessary in its business. The corporation usually will not admit the compensatory nature of the expense because of the effect on the recipient, but an attempt is almost always made to establish that the expenditure was necessary to promote its business. Except in worthy cases these attempts are unsuccessful, and the recipient faces the burden of including the value of what he has received in income. Although it may not be possible to eliminate the tax entirely, a substantial service can be done if the value of what the employee is considered to have received is minimized. Taxpayers' representatives sometimes direct too much of their effort to the hopeless task of justifying the "primary" business nature of the expense and too little to an attempt to minimize the tax dollars that will be assessed if the primary contention is not sustained.

Where cash payments are involved, little can be done to reduce the amount of income attributable to the recipient, as, for instance, where cash payments are made to cover travel and entertainment expenses, the business purpose of which cannot ultimately be substantiated. But where the benefit is given in the form of the use of a boat, a piece of residential or resort property, or the construction of an improvement on an employee's property, there is usually a basis for negotiating lower valuation.

In most of these cases the Government may contend that the income should be measured by the amount of the corporate outlay for maintenance plus depreciation charges on the supposition that the employee is benefited by the amount the corporation expends in his behalf. The true measure of income, however, is the value to the employee of the right to use the property. Fair rental value is more appropriate, and this may even be excessive if the recipient does not have the opportunity to use the property entirely for his personal purposes.

There is some business motivation, though it may not be the primary motivation, in most cases where a corporation permits its employees to use its property. There is seldom absolutely nothing to support the recipients' contention that there is a business connection, and the property is usually used to some extent for business purposes. If

the employee takes the property with the understanding that he is to entertain corporate clients, and does so, there is quite a reasonable basis for reducing the fair rental value of the property that would otherwise apply because of the condition under which he is permitted to use it. It is not worth to him what it may be worth to someone else who is not required to so conduct corporate business.

As an illustration, assume a corporation permits its president to use an $80,000 yacht for an entire year, with the understanding that, when called upon, he will entertain corporate customers. The president is able to show that on 20 out of 50 occasions during the year the yacht was used to comply with this agreement. Whatever the fair rental value of the yacht may be without these restrictions, it seems that, to the president, the yacht is worth a substantially lesser amount. Even though primary business purposes cannot be proved, a compromise result may nevertheless be obtained by attacking the valuation side of the matter.

One of the more common cases in this area is the use by an officer of a residence owned by his corporation, which the corporation purchased particularly for this purpose. The fair rental value of the residence is often substantially less than maintenance expenses and depreciation charges, and Government claims of value can often be reduced. It is essential that competent appraisals be obtained to determine this. Although it is usually impossible to establish business reasons for the arrangement, evidence of fair valuation may be helpful. In a recent Tax Court case corporate officers proved that they had no additional income where they paid only $7,200 for property that cost the corporation in excess of $20,000 to maintain (including depreciation charges). The fact that they actually used the property for only part of the year weighed heavily in their favor, although they had an opportunity to use it for the entire year. Discrepancies of this size do not often happen, but some difference seems to be the rule rather than the exception. And we must not lose sight of the fact that this argument can cut the other way. It may cost the corporation only $7,200 in maintenance and depreciation charges to provide its officers with benefits worth $20,000.

One of the areas in which these principles can be most fruitfully applied is in compensatory improvements to an employee's property. Suppose a corporation remodels its president's home or constructs a swimming pool on his property. The president does not receive the money the corporation spends, but he does receive an improvement to his property having a value in an amount by which the over-all value of his property is enhanced. A swimming pool seldom increases the value of property by the amount it costs to put it there. Value before the improvements compared to value after, rather than the amount the corporation spends, should measure the amount of income. This idea, however, its not widely accepted. It is not often argued. It is in line with rules, for instance, in casualty loss cases where value before compared to value after, rather than the cost of repair, measures the loss.

Corporations have been known to construct improvements on property rented by it from officers on a short-term basis. In many cases the improvements peculiarly satisfy the corporation's own business needs and do not tend to increase the value of the property in an amount bearing any relation to the amount expended, since the additions have little or no worth to others. If the officer is taxed as a result of the expenditures and there is a body of authority for doing so, it would be manifestly unfair to measure the value of what he has received by the corporate outlay. He has not received this outlay nor has he been benefited by the amount of the outlay. In such cases he should be taxed only on the amount by which the realizable value of his property, if any, is enhanced by the improvement or addition. In some cases this value may actually be decreased. In several cases of record this distinction has not been recognized, and the officer was taxed on an inflated amount that he did not in fact receive or could ever hope to realize. The corporate outlay just cannot be blindly considered the true measure of income.

These are but a few of the many situations where the methods of measuring compensation deserve careful consideration. In the years ahead, compensatory fringe benefits will unquestionably receive careful attention by the Service, and the proof necessary to establish primary business purpose will become more rigid. This attitude is repeatedly expressed by the Commissioner and is being sustained by the courts. It is incumbent upon taxpayers' representatives to be alert to the means to show that the amount of income their client has received is less than the Government contends it is. Some of the methods mentioned above are not as yet well established principles of the income tax law, but it seems that they should be if proof and argument are adequate in litigated cases. Taxation of such fringe benefits to employee recipients is an advent of recent times. The shape the legal precedent in this area will take will depend largely on the imagination of those handling litigated matters. We hope they do justice to others who depend on the principles their cases will establish. ☆

[*Thomas J. Donnelly, Jr., is a member of the Wisconsin bar and the firm of Brady, Tyrrell & Bruce in Milwaukee.*]

BACK COPIES WANTED

The following issues of The Journal of Taxation are out of print. We would like to purchase copies of these in good condition at $1.50 each.

1954: June, Sept., Oct., Nov.
1955: May, Aug., Sept., Oct.
1957: Feb., June

Write, Journal of Taxation, 147 E. 50th St., New York 22

ACCOUNTS RECEIVABLE LOANS
LOWEST RATES
NON-NOTIFICATION

SERVICE FACTORS CO.
450 SEVENTH AVE. NEW YORK, N. Y.

Serving Your Clients 25 Years

Morton Jolles **LA. 4-7661**

NEW DEVELOPMENTS IN TAX ASPECTS OF

Accounting

EDITED BY CARL M. ESENOFF, CPA, & C. W. LAMDEN, Ph.D., CPA

Milwaukee & Suburban decision may lead to new concept of estimated expense deductions

by THOMAS J. DONNELLY, JR.

The Code provisions dealing with accounting methods focus on the idea of clearly reflecting taxable income; courts have developed doctrines for testing individual items of income (claim of right) and of expense (fixed and determined). These tests are often incompatible with the idea of clearly reflecting income. As Mr. Donnelly explains, Milwaukee & Suburban, by concentrating on the reasonableness of the over-all result, creates the hope that the tide has turned and that the claim of right and the fixed and determinable doctrines are giving way to the statutory test of clearly reflecting income. But the Supreme Court stands in the path of progress in this area.

ONE OF THE MOST CONTROVERSIAL areas of the tax law these days is the matter of the deferral of receipts for services to be rendered in a later year and, on the other side of the coin, the deduction of expenses incurred when the liability is not fixed or determinable. The court of appeals decision in *Milwaukee & Suburban Transport Corp.* (CA-7, 10/24/60, *rev'g* 18 TCM 1039) sheds light on the expense side of this question. It approved a municipal transit company's system of accruing unpaid amounts for accident claims in the year in which the accidents occurred, even though the final determination of the existence of liability and the amount came in a later year.

Coincidently, within the same week the Court of Appeals for the Eighth Circuit, in *Schlude* (CA-8, 10/19/60)[1] reversed the Tax Court (32 TC 1271) on the deferral-of-income side of this question. It held that receipts for dancing lessons may be deferred until the later year in which the lessons are given. These two cases focus on the concept of matching revenues with related expenditures on a basis consistent with generally accepted accounting practice. The considerations on both the income and expense side of the question are similar.

These decisions are remarkable in the light of the Supreme Court's holding in *Automobile Club of Michigan* (353 U. S. 180 (1957)). The court in the *Schlude* case distinguished *Automobile Club,* but the court in *Milwaukee & Suburban* did not even make an attempt to do so.

Automobile Club of Michigan considered the question of whether receipts for auto club memberships may be deferred until later years in which the auto club contended they were earned. The club deferred income from dues ratably over a 12-month period on the theory that its services were performed over such a period and the deferral was essential to clearly reflect its income. Perhaps the most significant statement in the opinion is as follows:

"The pro rata allocation of the membership dues in monthly amounts is purely artificial and bears no relation to the services which petitioner may in fact be called upon to render for the member."

This appears to be a fair statement. The auto club's services were not necessarily spread evenly over a 12-month period; at least the record did not disclose evidence that this was the case. Quite to the contrary, it was apparent that a substantial portion of the dues were applied not to services to members at all but rather to other of the ordinary functions the club served. On the other hand, expenditures for its services and other functions were not concentrated about the time the annual membership fee was paid and were obviously fairly evenly spread over a 12-month period, although not precisely one-twelfth each month.

Justice Harlan commented on this in his dissenting opinion as follows:

"The method of accounting used by the taxpayer reflects its net earnings with considerably more accuracy than the method [the Commissioner] proposes."

It would be difficult to contradict this. The method used by the auto club did not accrue income with precise mathematical accuracy in respect of each individual payment it received but over the long term it did allocate income with as much fairness as could be expected of any accounting system. The majority, however, seemed unconcerned with this and insisted on precise correlation with expense.

The Supreme Court apparently means to say that income must be reported in the year of receipt unless the taxpayer's system of accounting permits a determination of the precise moment the paid-for services are rendered without resort to approximations, averages, or artifice of any sort. The problem then is not one of choosing the method of accounting that most clearly reflects income but, rather, of overcoming the Commissioner's determination that income should be reported in the year of receipt by a strong showing of the precise moment it is, in fact, earned. The claim-of-right concept can be, it seems, dissolved only by such evidence. Few accounting systems are capable of this, and the complexities of a system that could do it would, in most cases, be overwhelming.

Sections 451(a)[2] and 446(a) and (b),[3] read together, authorize a deferral of income received in one year to a later year if this is appropriate under the method of accounting regularly employed by the taxpayer in keeping his books, so long as such method clearly reflects income. The matching of receipts with related expenditures is not a prerequisite. Just how these statutory provisions accord with claim of right is an unresolved matter. Certainly the Supreme Court's *Automobile Club of Michigan* decision solves but a fraction of the problems in this area. There is

a head-on conflict between the court-made claim-of-right theory and the statutory authority for reporting taxable income in accordance with a system of accounting that "clearly reflects income." This is a conflict that the courts choosing either theory consistently ignore. The recitation of the claim-of-right theory seems to be the usual manner of saying that a method of deferral of income does not clearly reflect income, just as the use of the fixed and determined liability concept is often the language used to say that a method of accrual of expense does not clearly reflect income.

Bressner and Streight

Two other recent decisions bearing on this question are *Bressner Radio, Inc.* (CA-2, 1959, 276 F.2d 520, *rev'g* 28 TC 378) and *Streight Radio and Television, Inc.* (CA-7, 1960, — F.2d —, *aff'g* 33 TC 127). *Bressner* and *Streight* allocated 15% and 25% respectively of their television service contract receipts to installation costs, and each then accrued as income one-twelfth of the remainder each month over the 12-month life of the contracts. This, of course, deferred a substantial portion of the amount received to a later year. The Tax Court disapproved the method of accounting used in both cases and required immediate inclusion of the receipts. On appeal *Bressner* won an approval of its accounting system, but *Streight* did not. Is there a difference in these two cases other than the identity of the courts to which they were appealed?

In *Bressner* the taxpayer produced evidence to show that its service contracts required service calls regularly throughout a 12-month period. In *Streight* the record did not disclose similar evidence, and the court seemed obliged to follow *Automobile Club of Michigan*. In *Bressner*, the court held the proof to be sufficient to establish that the particular proration used reasonably matched actual expenses with the earning of related revenues. The court reasoned that this was not so in *Automobile Club of Michigan*. The facts, however, do not disclose overly persuasive distinctions. In both cases it was apparent that the services justifying the receipts were to be rendered in later years, but in both instances resort to artifice of some sort was necessary to establish deferral schedules.

All of the deferral-of-income cases mentioned above consider the extent to which the evidence establishes a definite future obligation to render services. The ability to match revenues precisely with related expenditures is the crucial question and seems to be the basis on which the claim-of-right theory may be discarded.[4]

Expense accrual cases

Milwaukee & Suburban Transport Corp. involves another aspect of these principles, that is, the accrual of expense rather than the deferral of income. But the basic consideration—whether the method of accounting employed by the taxpayer clearly reflects income—is precisely the same. The Supreme Court's concept of what is necessary to clearly reflect income must be taken into account. In other words, can the taxpayer adequately match its claimed accrual with a related future expenditure? The expense side of the question also involves a consideration of rules authorizing the accrual of an expense only when the liability becomes fixed and determined, the counterpart of the claim-of-right doctrine that weaves its way into a consideration of the deferral-of-income cases. But should either of these doctrines be applied if the deferral or accrual is essential to reflect income clearly?

[*Thomas J. Donnelly, Jr., is a member of the Wisconsin bar and is associated with the Milwaukee law firm of Brady, Tyrrell & Bruce.*]

The idea of accruing an expense before a precise liability is incurred is not a new one, but in the cases where such an accrual has been sustained by the courts a fairly precise amount was determinable in respect of an item of expense that most certainly would be incurred at some time in the future. The Tax Court found these elements nonexistent in respect of a common carrier's reserve for unsettled claims for loss and damage to freight in *Denver & Rio Grande Western Railroad Co.* (32 TC 43 (1959) *aff'd* on other issues CA-10, 1960, 279 F.2d 268), a case quite similar on its facts to *Milwaukee & Suburban Transport Corp.*

Several courts of appeals have approved deductions for anticipated expense where the amount of the expense is precisely known and the ultimate liability crystal clear.[5] In some of these cases estimates were employed to determine the amount to be accrued. In *Denise Coal Co.* (CA-3, 1959, 271 F.2d 950) the court made quite a point of the fixed obligation of the taxpayer under state law to replace overburden caused by strip mining and the accuracy with which the cost of doing it could be determined but it did not require estimates with mathematical exactitude. It approved a deduction for an estimated amount that the taxpayer claimed would ultimately be incurred to discharge its fixed obligation. This case bears a striking resemblance to *Milwaukee & Suburban Transport Corp.*, although the obvious distinction is that the obligation in *Denise* was fixed and certain.

Milwaukee & Suburban Transport Corp. is a local public transit company doing business in and around Milwaukee, Wisconsin. During each of the years in issue it was involved in over 5,000 accidents and was, for all practical purposes, a self-insurer. By the end of the years involved many of the claims filed in respect of its accidents had not been settled; some were then (or later became) the subject of litigation; some were still awaiting the filing of a claim, and claims have never been filed on some of these.

At the end of each of the years in issue taxpayer appointed a committee to appraise its claims, and based on the

---

[1] The Justice Department has announced that it will request certiorari.

[2] "Section 451(a) . . . The amount of any item of gross income shall be included in gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period." Section 451(a) is similar to Section 42(a), 1939 IRC.

[3] "Section 446(a) General Rule.—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books."

"(b) Exceptions.—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income."

Section 446(a) and (b) is similar to Section 41, 1939 IRC.

[4] For a further discussion of the *Bressner, Schlude,* and *Streight* cases, see an article by John M. Sullivan entitled "Streight and Schlude follow Bressner analysis of prepaid income" in the January issue of THE JOURNAL OF TAXATION (14 JTAX 2).

[5] In this connection see *Pacific Grape Products Co.* (CA-9, 1955, 219 F.2d 862, *rev'g* 17 TC 1097); *Paul Harrold* (CA-4, 1952, 192 F.2d 1002); *Denise Coal Co.* (CA-3, 1959, 271 F.2d 930). To the contrary, where the taxpayer failed to show that its estimates were reasonable, *Patch* (CA-3, 1954, 208 F.2d 532, *aff'g* 19 TC 189); *Jenkins* (CA-3, 1955, 217 F.2d 950); *Gregory Run Coal Co.* (CA-4, 1954, 212 F.2d 52, *aff'g* 19 TC 501, *cert. den.* 358 U.S. 828).

TABLE I: *Taxpayer's Appraisal of Claims*

Year	*Number of outstanding claims*	*Taxpayer's appraisal*	*Payments to August 31, 1958, plus estimates on claims then not settled*
1953	414	$254,659.00	$192,730.24
1954	447	161,136.50	211,266.84

appraisals an expense was accrued on its books, a reserve set up for the accrued amount and a corresponding deduction taken for income tax purposes. Taxpayer's experience in appraising claims for the years 1953 and 1954 is summarized in the accompanying table.

The appraised amounts vary widely from actual experience in the vast majority of cases. Only approximately 10% were settled for the amount of the estimate, and almost 40% were settled for amounts varying more than 100% from the estimate. If each claim is considered separately, the conclusion is inescapable that the estimates do not match the liabilities ultimately incurred with any impressive degree of accuracy.

The accuracy of the over-all estimate is impressive only when the two years in issue are combined, and even then the appraisals vary widely from actual experience if the appraisals are reduced, as they should be, by the amounts assigned to accident cases on which claims have never been filed. The combined two-year summary making this adjustment is as follows:

Total appraisals	$415,795.50
Amounts assigned to claims not ultimately filed .	60,991.00
Remainder	$354,804.50
Payments, plus appraisals on claims not settled by August 31, 1958	$403,997.08

The court determined that the appraisal system was taxpayer's method of accounting for unsettled claims, that such method clearly reflects income, and that the Commissioner abused his discretion in failing to determine that it is acceptable.

Reflects income despite averaging

The accrued amounts for unsettled accident claims for which the company successfully claimed a deduction were based on averages compounded on estimates. Unless a substantial number of claims are involved, the probability is that the errors will not cancel each other as well as they did here. What would the result have been if one-tenth of the number of claims were involved and the ultimate percentage of discrepancy ten times as great? How can we determine that such a system clearly reflects income until many years after the returns are due and the accuracy of the estimates established? The court could hardly have concluded that, at the close of the year for which they were made, these estimates were reasonable.

The Tax Court found that the taxpayer's liability for claims, considering the claims individually, could not be estimated with any reasonable certainty. The court of appeals, however, said:

"While it is apparent from these figures that petitioner was not able to estimate its liability with mathematical precision, this need not deter the deduction, for it is only necessary that the estimate be reasonably certain."

Auto club is contra

How does this statement compare to the Supreme Court's requirements expressed in *Automobile Club of Michigan*? Is the artifice to which the Supreme Court referred evidenced by the use of averages compounded on estimates? There is no doubt that the Automobile Club of Michigan was required to perform services for its members in the year following the receipt of membership dues and that the dues were paid to support the club in its activities during the following year. But the club could not match with any mathematical precision its receipts with related expenditures. It could show only that it performs services on a 12-month basis. It is likewise apparent that Milwaukee & Suburban would incur, in later years, liabilities for accidents arising out of its operations during the years in issue. But it could not match with any mathematical precision its estimates for unsettled claims with a precise liability it would ultimately incur. Only by reliance on averages do the estimates make sense in their final analysis.

The word "artificial" has many meanings, and it is difficult to forecast just what the Supreme Court had in mind in employing it. One of its more common meanings is "man-made." It seems that a system of calculating expenses by resort to estimates and averages is "man-made." Any system of accrual that fails to match actual outlays with related accruals may be open to the criticism that it is "artificial."

If the Supreme Court's decision means, as it probably does, that expense accruals must be matched with related outlays and that this cannot be accomplished by resort to estimates and averages, then each of Milwaukee & Suburban's outstanding claims must individually meet the prescribed test. When the claims are considered individually, it seems apparent, and the Tax Court so found, that they were not fixed liabilities or determinable in amount at the close of the years for which the estimates were made. In this event a deduction is permitted only at such time as the liability becomes fixed and determined.

On the other hand, a contention that the system Milwaukee & Suburban employed to relate its liabilities for accidents to the revenues of the operational year producing the accidents *does* reflect income as clearly as any system of accounting could be expected to do seems difficult to overcome. But is this alone sufficient to justify the deduction? The statutory authority mentioned above (Sections 451(a) and 446(a)) indicates that it is. But the Supreme Court from all appearances does not agree. Its opinion in *Automobile Club of Michigan* did not actually consider whether another method of accounting would more accurately allocate the auto club's receipts to the years to which they most appropriately pertain; its opinion simply disapproved the method of accounting because it was artificial and failed to match revenues and expenditures adequately. It seems to imply that no matter how well a system of accounting may actually reflect income, it must be bottomed on solid rock and not on approximations. The *Milwaukee & Suburban* case does not adopt these views and is very likely in conflict with the Supreme Court's leanings on the subject, although it seems to be a case where a strong showing was made that the method of accrual employed clearly reflects income.

If the *Milwaukee & Suburban* decision can withstand the test of time, it may open the door to estitmated expense deductions that just a short time ago seemed out of reach. It approved the type of estimated-expense deduction Congress apparently intended to authorize for accrual-basis taxpayers by

the former Section 462 of the 1954 Code. Is it now possible for a taxpayer to obtain the benefits of this repealed Code section on the premise that an accrual of estimated expense is essential to clearly reflect income?

Although the Supreme Court has agreed to again review this question (see *American Automobile Association,* Ct. Cls., 3/2/60, 181 F.Supp. 255, *cert. granted* 10/10/60), it may be many years before it is entirely resolved in all of its ramifications. Only time will tell whether the Supreme Court will resolve the conflict between the claim-of-right and the fixed-and-determined-liability theories on one hand and accounting systems that clearly reflect income on the other. Perhaps in the process a rule will be evolved that will be logically consistent with generally accepted accounting principles. In the meantime, it seems appropriate for accrual-basis taxpayers to defer income and to accrue expenses whenever a reasonable basis can be found, so long as the deferral or accrual is reasonably calculated to reflect income clearly. Furthermore, it is imperative that taxpayers devise reasonable ways and means to demonstrate the relation between accruals and outlays and between deferrals and expenditures, for this evidence is the weapon with which the battle must be waged. ☆

CLE's books on taxes are best sellers

THREE HUNDRED THOUSAND is a lot of books, but that's about how many have been sold by the Joint Committee on Continuing Legal Education of the American Law Institute and the American Bar Association, publishers of *The Practical Lawyer.*

Among the 16 best sellers are many pertaining to taxes: *Basic Accounting for Lawyers* has sold almost 20,000 copies and *Procedure before the Internal Revenue Service* more than 10,000. *The Preparation and Trial of Cases in the Tax Court of the United States* may be pushed off the list by two newer books enjoying brisk sales, *Federal Income Taxation of Individuals* and *Federal Income Taxation of Corporations.*

Six of the eight books now in preparation are on tax problems of one sort or another, and announcement of their publication as well as copies of books now in print may be obtained from the Committee at 133 South 36th Street, Philadelphia 4, Pennsylvania. All sell for $3 or $2.50 each for orders of four or more. ☆

New accounting decisions this month

NOL increased for state income tax and cost of contest; Tax Court reverses itself. Taxpayer sought to deduct the following items in computing a net operating loss deduction: deficiencies in state income taxes, interest on Federal and state income tax deficiencies, and legal fees incurred in connection with contesting the assessments. In the computation of a net operating loss deduction, the Code allows nonbusiness deductions only to the extent of nonbusiness income. Noting that the deficiences were imposed with respect to business income, the Tax Court concludes that the state income tax and deficiencies, interest, and legal fees were closely enough related to taxpayer's business to be deductible from gross income from the business. Accordingly, they are allowed as deductions in computing the net operating loss deduction. In reaching its decision, the court repudiates its decision in *Aaron* (22 TC 1370), where the words "attributable to" a trade or business were strictly construed. After reviewing the Regulations and Committee Reports, the court decides to follow its decisions in *Standing* (28 TC 789) and *Polk* (31 TC 412), which gave a more liberal construction to the language of the Code. *Reise,* 35 TC No. 61.

Double deduction allowed to cash-basis taxpayer for foreign tax credit. During 1953 taxpayer, on the cash basis, paid income tax to Puerto Rico for the years 1946 and 1952. He incurred income tax liability to Puerto Rico for the year 1953. On his U. S. return taxpayer deducted both the amount paid in 1953 and the amount accrued during 1953. The court allows both deductions, holding that under Section 131 of the 1939 Code a cash-basis taxpayer can elect to deduct taxes accrued within the year and that such election does not require the disallowance of a double deduction if taxpayer has also paid taxes in that year. *Ferrer,* 35 TC No. 66.

Incomplete application for extension brings tax on involuntary conversion. Taxpayer realized a gain on condemnation of its real estate. It sought to avoid recognition of the gain by reinvesting the proceeds in other property within the time allowed by the Code but was unable to do so. Accordingly, taxpayer sought to obtain an extension by executing a surety bond and filing it with the Commissioner within the allowed period. However, the bond was not properly executed and, accordingly, the Tax Court rules that the gain is to be recognized. *Real Estate Corp., Inc.,* 35 TC No. 65.

Royalty taxable to corporation; beneficial interests in patent were never transferred to stockholders. A corporation that helped in the development of a drilling machine received from the inventor an assignment of 51% of the beneficial interest in the patent. The corporation "as trustee" sold its rights in the patent to a third party in return for royalty payments and agreed with its stockholders to pay the royalties to them after first reimbursing itself for its costs. The court holds the corporation was chargeable with all the royalty income, since it held the beneficial interest in the patent directly and not as "trustee," and it was not shown that it ever distributed this interest to its stockholders. *Greystone Granite Quarries, Inc.,* TCM 1961-16.

Executed sale held closed transaction; contingencies ascertainable in year of sale. Taxpayer was on the accrual basis and had a fiscal year ending May 31. It sold all its assets, with title and possession being taken by the purchaser in November 1955. The bulk of the purchase price was paid at that time, with the balance paid to an escrow agent to guarantee delivery of good title. Taxpayer made a series of repayments to the purchaser from June 1956 to March 1957 on account of various adjustments. The title abstracts required by the contract were not completed by the seller until the fiscal year 1957; the escrow fund was returned to taxpayer in October 1956 and March 1957. The court holds that the sale was a closed transaction in the fiscal year ended May 31, 1956, so that the entire capital gain had to be reported in that year. The taxpayer failed to prove that it could not ascertain at the end of that year the

necessity for repayments and their amounts. The mere showing that payments were subsequently made did not establish the contrary. Cases favorable to the taxpayer were distinguished as involving executory, not completed, contracts. *Consolidated Gas and Equipment Co. of America,* 35 TC No. 73.

Interest adjustment not required in EPT computation. Under the Korean excess profits tax, a new corporation paid a tax on its excess profits net income (without regard to any excess profits credit) at a lower rate. But this new corporation tax could not exceed the excess profits tax computed in the usual way. The court holds that in computing the tax for a new corporation, interest expense does not have to be added back to net income. This adjustment is required in the usual computation because of the way the excess profits credit is constructed. It has no application here. *Amana Refrigeration, Inc.,* Ct. Cls., 1/18/61.

Lumber company's installation of dry kiln is change of character for EPT relief. Taxpayer, a lumber manufacturer, prior to 1939 dried its lumber by air, which took from four weeks to six months. In 1939 it installed a dry kiln that could season its lumber in from 18 hours to six days. The court finds that taxpayer established a change in the character of its business during the base period under Section 722(b)(4) and is entitled to use a constructive average base period net income. The court disagrees with taxpayer's CABPNI computation, however, as to its estimated savings on the dry kiln and the anticipated level of earnings; the court computes its own CABPNI. *Crane Mills,* 35 TC No. 62.

Corporation formed with dissolved corporation's assets isn't new for EPT. A group of individuals in 1947 purchased the stock of a corporation engaged in the general dairy business and liquidated the corporation the next day; they then conveyed all the assets received on liquidation to taxpayer, a new corporation, which continued the dairy business. Taxpayer sought EPT relief, claiming it was a new corporation under Section 430(e) of the 1939 Code, which provides an alternative tax rate for a new corporation if that rate produces a lower tax. The court holds against taxpayer, finding that Section 430(e) was intended to benefit truly new corporations through lighter taxes during the early growth years of their existence and that taxpayer is not a new corporation, since its stockholders were stockholders of the prior corporation. *Robinson's Dairy, Inc.,* 35 TC No. 64.

Receipt could be for license or for sale; not taxable until decided. [*Non-acquiescence*] Taxpayer, owner of a trade mark, had licensed it for royalties under an agreement giving the user an option to buy it for $350,000. The user could extend the licensing period for another five years upon payment of $50,000. This payment would also extend the option but at the reduced price of $300,000. The user paid taxpayer the $50,000 to extend the license and the option. Taxpayer sought to defer the reporting of this amount until the purchase option either lapses or is exercised. The Commissioner contended that the money was received under a claim of right with no restriction as to use, for the extension of the license agreement, and should therefore be reported as ordinary income in the year received. The Tax Court, although conceding that the payment was made, at least in part, for the extension, found that the variation in price between the two purchase options indicated also an intent that the $50,000 be applied against the purchase price. After noting the difficulty in resolving this issue, the court decided that taxpayer may wait until the purchase option is exercised or lapses. Citing *Virginia Iron Coal and Coke Co.* (37 BTA 195, *aff'd.* 99 F.2d 919), the court stated that such delay is necessary in order to determine whether the payment is ordinary income or capital gain from the sale of the trademark. *The Dill Co.,* 33 TC 196, *non-acq.,* IRB 1961-4.

Demolition loss of building allowed; acquisition was not with intent to demolish. A claimed loss on the sale at auction of a restaurant building is allowed where taxpayer showed that he did not intend to demolish the building at the time of acquisition of the land, but only intended to move it to another part of the real estate. It was only when he discovered that the plan to move the building would not be feasible that he decided to sell the structure. *Almac's, Inc.,* TCM 1961-13.

Cancellation of indebtedness results in taxable income. Pursuant to an employment termination agreement, taxpayer's employer cancelled personal loans due from taxpayer in the amount of $3,000 and paid off his personal debts in a similar amount. The total amount of the cancellation and payment of debts is held to be taxable income to taxpayer, in spite of his allegations that the payments were intended to settle a tort liability for libel and slander owed by the employer to the employee and that the cancellation "was nugatory and of no financial benefit." *Silver,* TCM 1961-6.

Unemployment payment from private welfare fund is income to recipient. Taxpayer, a railroad employee and a member of a railroad union relief fund, paid a total of $224 to the fund, which was maintained as a separate corporation to pay benefits to members who were "held out of service" (laid off) or retired. In 1955 taxpayer was held out of service and was paid $2,400 by the fund. The Commissioner contended that the entire amount received, less $224, should be included in gross income. The court agrees, holding that payments can be income even though services are not performed and the payments are not earned and that unemployment payments from private, as opposed to public welfare, funds are gross income. The payments were made under a contractual arrangement, were not gratuities or a replacement of capital, but were a replacement of lost wages that would have been taxable as ordinary income if they had been received by taxpayer. *Williams,* 35 TC No. 74.

Payment for movie rights was for release of privacy and is ordinary income. Taxpayers, the children of a deceased Naval officer whose written material, "We Plaster the Japs" was used in a film, received $5,800 from Loew's, Inc., for authorizing the use of the material for a motion picture. Taxpayers argued that, since the material was based on the life of their father, the payment was made for a consent to an invasion of privacy and should, therefore, not be taxed. Section 104(a)(2) of the 1954 Code allows an exclusion from gross income of damages received for personal injuries. In the absence of a showing that there was any actual invasion of privacy, the Tax Court rules that the amount is taxable. The court points out that it need not decide the question of

whether money paid to obtain a release for a right of future privacy invasion should be excluded from taxable income where such invasion actually followed. *Starrels,* 35 TC No. 69.

Payments to officers' widows not gifts. By resolution of the board of directors of Russeks Fifth Avenue, the corporation agreed to pay the widows, in the event of the death of designated officer-stockholders, the sum of $100 weekly for life. Payments received by two widows in excess of $5,000 each are held to be taxable income and not gifts. There was no evidence that the payments were motivated in any part by the widow's needs or by a sense of generosity or the like. *Russek Estate,* TCM 1961-28.

CAPITAL GAINS

Producer has some ordinary income, some capital gain on termination of movie contracts. Taxpayer, a motion picture producer, and his partnership entered into two agreements with Paramount to produce 11 motion pictures. Taxpayer was to receive a fixed fee of $15,000 or $20,000 for each picture produced and a 25% participating interest in the excess gross receipts of the pictures over and above specified costs. After 9 of the 11 pictures had been produced, taxpayer and Paramount entered into an agreement terminating the two production agreements, for which Paramount paid taxpayer $153,000, and taxpayer released Paramount from all obligations to produce the remaining two pictures and from making any further payments to taxpayer under the excess gross receipts provisions. At about the same time, taxpayer bought the two unproduced pictures from Paramount for $500, one of which was later sold for $15,000. Taxpayer sought capital gain treatment for both the receipt of $153,000 and the sale of the unproduced movie. With respect to the $153,000, the Tax Court rules that the amount was not a return of capital but merely a substitute for receipts that would have been included as compensation for services rendered if received under the original agreements. Accordingly, the $153,000 is ordinary income. The court finds that the unproduced motion picture story sold by taxpayer was a capital asset and that its sale resulted in capital gain. The court rejects the Commissioner's contention that the acquisition by taxpayer of the movie was a "bargain sale" in connection with the termination agreement and was, therefore, additional compensation to him for past services. The transaction was at arm's length and taxpayer and his partnership assumed all remaining obligations under the writers' contracts. *Holt,* 35 TC No. 63.

Ordinary income on sale of unimproved land. Taxpayer is a corporation formed by the shareholders of a bank to hold title to lots acquired at tax sales. Under local law, the bank would not have been permitted to engage in these activities. The Tax Court rules that gain on sale of the lots is ordinary income. Sales were frequent and continuous and constituted a large portion of taxpayer's total activity; the property was held primarily for sale to customers in the ordinary course of business. It is immaterial that taxpayer did not advertise the lots and did not solicit sales. *Real Estate Corp., Inc.,* 35 TC No. 65.

Widow has ordinary income on grant of movie rights on life of her husband. Glenn Miller died in 1944 and taxpayer, his wife, was his sole beneficiary. In 1952 taxpayer and a motion picture company entered into a contract whereby taxpayer (1) granted the company the right to produce a picture based on the life of Glenn Miller, (2) agreed to release all her claims for violation of the right to privacy, and (3) agreed to attempt to obtain similar release from the members of the family (which she subsequently obtained). Taxpayer received a percentage of the profits. In 1954 she reported one-third of her receipts as ordinary income and two-thirds as exempt as a nontaxable receipt for a release of her right to privacy. In her petition taxpayer changed her theory and claimed that the entire payment was capital gain, since she sold a capital asset, *i.e.* the exclusive right to produce a movie based on the life of Glenn Miller. The court disagrees, finding part of the receipts represents (1) the release of the right to privacy, which results in ordinary income, and (2) taxpayer's performance of services, e.g., the obtaining of releases from other members of the family. The remainder of the payments also represents ordinary income, since the grant of the right to make a picture of the life of Glenn Miller (the facts of which were in the public domain) was no more than a release of an alleged right petitioner claimed existed; there is no indication that she owned the right and, even assuming that Glenn Miller had that right, taxpayer has not shown she succeeded to that right. *Miller,* 35 TC No. 68.

Capital gain on transfer of literary property by actor under contract to act in the production gives rise to capital gain. Taxpayer, José Ferrer, held an interest in a literary property and, in the contract by which he acquired the interest, agreed to perform in its production. He transferred his interest in the literary property, claiming capital gain treatment. Taxpayer was not, the court finds, in the business of dealing in literary properties, and his interest was not held for sale to customer in the ordinary course of business. The court holds that his literary interest is a separate and distinct interest, a capital asset in taxpayer's hands, and upon transfer gives rise to capital gains. *Ferrer,* 35 TC No. 66.

Allocation made between long-term and short-term capital gain. On the first appeal, a certain tanker, purchased when only partly complete, was held to be a capital asset, and the taxpayer realized both long-term and short-term capital gain from its sale of the tanker. The case was remanded to the Tax Court to allocate the taxpayer's profit between long-term and short-term capital gain. On remand, the Tax Court held that 20.6% of the gain was long-term capital gain and 79.4% was short-term capital gain, allocating the gain on a percentage basis proportionate to the expenditures made by the taxpayer before and after the six months' holding period for determining long-term capital gain. The taxpayer contended that the allocation was in error, alleging that $187,500 of work done by a third party was not part of its cost of acquisition and should be excluded completely from the cost of acquisition and of the selling price. In the alternative, the taxpayer argued that the allocation of gain should be made on the basis of value instead of cost. This court holds that both contentions are without merit. Money paid to enlarge and improve the vessel in order to sell the vessel at a profit was clearly a payment for its benefit and must be included in determining both cost and sales price. As to the alternative contention of allocation based on value instead of cost, this court points

out that value is used to allocate basis when part of a larger property, acquired for a lump sum, is sold. This decision says that portions of the purchase price paid before and after the six-month cut-off date contributed proportionately to the gain resulting from the sale of the whole. Thus, the Tax Court acted properly in allocating gain on the sale of the whole by measuring the cost of the parts. *Williams,* CA-5, 1/12/61.

Builder has ordinary income on package construction. Taxpayer, a builder, occasionally engaged in package building construction. In that kind of job he procures the building site, obtains financing, does the actual construction, and delivers the finished project to a purchaser. Here, taxpayer was asked to furnish a warehouse on a package basis. Taxpayer purchased land in his name and arranged for financing. Since the financing arrangements required it, taxpayer obtained a purchase commitment from Prudential Insurance Company and negotiated a lease with the ultimate user of the warehouse. Taxpayer then constructed the building through his controlled construction corporation, sold it to Prudential subject to the lease, and reported capital gain. The Tax Court finds that taxpayer has ordinary income on the ground that he was in the regular business of package construction and, therefore, the asset sold was held primarily for sale to customers. The Third Circuit affirmed. *Heebner, cert. den.,* 12/12/60.

Capital gain on first land sale; one deal didn't make a dealer. Three taxpayers—a real estate broker, an attorney, and a hospital administrator—joined together to acquire two contiguous tracts for purposes of industrial development. Before they carried out those purposes, an offer to buy was presented to them at a price they could not afford to refuse. So they sold. The court holds the one sale is not enough to translate their original investment intent at the time of purchase into an intent to hold the land for sale in the ordinary course of business. Accordingly, they properly characterized their gains as long-term capital gains. *Kirsch,* TCM 1961-20.

Sale of stock was really sale of Maritime Commission rights; income was ordinary. The Maritime Commission adopted a policy whereby companies promising to build U.S.-flag ships would be permitted to transfer equivalent tonnage to foreign registry. The privilege applied to single companies or to related groups. Although the transaction here ruled upon was in form a sale of stock by a company planning to build U.S.-flag vessels to one that wanted to transfer a ship to foreign registry, the IRS rules that in fact the stock sale merely permitted the two companies to qualify as related under the Maritime Commission rules. In reality the valuable privilege of transferring a ship to foreign registry had been sold, and gain on the sale is ordinary income; the privilege is not a property right. *Rev. Rul.* 61-18.

Losses in commodity futures were capital losses. The taxpayer was in the livestock business, buying cattle, hogs, and lambs from farmers and at auctions. On at least two prior occasions, he had suffered severe business reverses. He consulted an economic adviser, who suggested that he protect himself by commodity futures, on the ground that livestock and the specific commodities are influenced by the same economic pressures. During the tax years in question, he suffered losses on commodities transactions, which he claimed as an ordinary deduction from hedging operations. The case was tried before a jury, which rendered a verdict for the taxpayer. This court reverses. According to the majority opinion, the evidence did not show a sufficiently direct relation between the cattle business and commodity futures. The dissent argued that this was a question of fact that had been decided favorably to the taxpayer by the jury, and the jury's verdict should not be disturbed. *Rogers,* CA-6, 1/27/61.

Cancellation of indebtedness by purchaser of business is ordinary income to seller. Taxpayer sold his business of purchasing, warehousing, and selling fire bricks, which he conducted as an individual proprietorship. The purchaser was the largest creditor of the business and, as part of the sale, this liability was canceled; in addition, the purchaser assumed all the other liabilities of the business. At the time of the transfer the total liabilities of the business exceeded its total assets. The Commissioner contended that this excess is ordinary income, since it resulted from the purchaser's cancellation of indebtedness; taxpayer argued that this excess is capital gain resulting from the sale of good will. The court holds against taxpayer, finding that taxpayer has not shown either that the business possessed good will or that the excess was payment for good will. Taxpayer was personally liable for the indebtedness, and there is no basis for finding that the cancellation of indebtedness did not free assets of the taxpayer. The court further finds that the assets transferred were inventories and accounts receivables and that any gain on the sale of such assets would be ordinary income. *Bialock,* 35 TC No. 70.

Payment on termination of employment agreement ordinary income. Taxpayer became an employee of a corporation whose stock was owned by his brother and sister-in-law under an oral agreement to receive as salary for his services one-half of the corporate net income. When he terminated his employment, taxpayer received a lump-sum payment, which he alleged was the proceeds from the sale of his interest in the corporation to his brother. But since he failed to prove that he had ever acquired an interest in the corporation, the lump-sum payment is taxable as salary. *Colin,* TCM 1961-31.

Sale v. lease of sand and gravel deposits. Taxpayer gave a construction company the right to remove sand and gravel deposits from its land. Taxpayer was to receive a certain price per unit removed, $1,000 payable in advance. Taxpayer treated the transaction as the sale of a capital asset and reported capital gain. The Tax Court rules it is ordinary income on the ground that the transaction was a lease rather than a sale. The contract did not mention a specific or approximate quantity of sand or gravel that could be removed; the agreement did not contain any language purporting to be a conveyance or transfer of all of taxpayer's right, title, or interest in the sand and gravel, and the "purchaser" was not obligated to remove or pay for the sand and gravel comprising the subject matter of the agreement. The value of the land was greater after the removal of the deposits. The court factually distinguishes several similar cases that recognized a sale, including *Dann* (30 TC 499). Three dissenting judges find the facts here indistinguishable from *Dann* and would allow capital gain. They stress the facts that taxpayer sold the material for a fixed price per unit removed and that he was not to

share in any profit or income derived by the vendee from the removal of the material. *Linehan,* 35 TC No. 57.

BAD DEBTS

Advances not considered worthless in taxable year. A bad debt deduction for advances to a corporation is denied on the ground that it had not been shown by objective standards that the debt became totally worthless during the taxable year. *Marshall,* TCM 1960-288.

Business bad debt determined. [*Acquiescence*] Taxpayers were in the business of organizing, financing, and operating corporations and business ventures. Taxpayers' loan to a corporation disallowed the business bad debt deduction claimed by taxpayers and allowed only a nonbusiness bad debt deduction treated as a short-term capital loss. The Tax Court held that the question is one of fact and that, since taxpayers were in the business of organizing, financing, and operating corporations, the bad debts are business bad debts. *Alexander,* 34 TC No. 78, *acq.,* IRB 1961-4.

Brother-in-law's debt not proved worthless; deduction disallowed. Taxpayer guaranteed his brother-in-law's debt at the bank; the proceeds were used by the brother-in-law in establishing a dental office. When his brother-in-law failed to pay the note when due, the taxpayer paid the obligation. Taxpayer took no legal action against his brother-in-law, even though he realized considerable income from his dental practice in subsequent years. The taxpayer claimed a deduction for the amount paid to the bank as a business bad debt. This court disallows the deduction for failure to show that a bona fide guaranty contract existed between the taxpayer and his brother-in-law and also for failure to show that his brother-in-law's obligation was worthless in the taxable year. *Wincorn,* DC Tex., 1/11/61.

Business bad debt only partially worthless in taxable year. Taxpayer, a wholesale commission merchant, had deducted as a bad debt in 1956 the entire sum of $74,000 due from one of his principal customers, a corporation that had been experiencing financial trouble and was under the surveillance of a creditors' committee. In the following year, after the creditors unsuccessfully attempted to keep the debtor going, the debtor filed a petition in bankruptcy and was adjudged a bankrupt. Upon ultimate liquidation of the debtor, taxpayer received 10% of his claim. The court finds that in 1956 the debt only became partially worthless to the extent of 50% thereof and holds taxpayer is entitled to a business bad debt deduction that year of $37,000. *Riley,* TCM 1961-10.

Loans to a corporation that had become insolvent are deductible as nonbusiness bad debts. Advances by taxpayer to a controlled corporation constituted nonbusiness bad debts upon becoming worthless. There was no contention that taxpayer was engaged in the business of lending money to corporations. Likewise, the amounts taxpayer was required to pay as cosigner or guarantor of corporate notes constituted nonbusiness bad debts. *Berner,* TCM 1961-23.

DEDUCTIBILITY

Advances to corporation considered capital contributions. Taxpayer had been engaged as a sole proprietor in selling certain equipment. He took on the sale of new products through a new corporation, which was undercapitalized. The sole proprietorship and the corporate business were conducted from the same address and had substantially the same customers and the same employees. Advances that taxpayer was required to make to the corporation to keep it going are held to constitute capital contributions rather than debts. Neither were they expenditures made to protect existing good will or prevent loss of earning by taxpayer's sole proprietorship, since they were never intended as such. *Dodd,* TCM 1961-8.

Lease cancellation cost a capital expenditure. A payment of $10,000 by taxpayer, a purchaser of realty, to a lessee then occupying the property to cancel the lease so as to enable taxpayer to demolish the leased premises and construct a new plant on the site is treated as part of the cost of the land and hence as a nondeductible capital expenditure. Taxpayer had also argued that the $10,000 cost should be amortizable over the remaining term of the lease, but the court finds the termination of the lease was accelerated, not so that taxpayer could utilize the unexpired term for further leasing but to enable him to clear the land as quickly as possible. There was no correlation between the payment and the period remaining in the old lease that would warrant amortization. *American Spring & Wire,* TCM 1961-26.

Disallowance of bonuses under Salary Stabilization Act upheld. The Defense Production Act of 1950 provided for disallowance as income tax deductions of amounts paid in violation of the salary stabilization regulations. The court holds it has power to review these determinations, at least as to Constitutional principles, and finds that the act is not an unconstitutional delegation of legislative power. *Oak Manufacturing Co.,* DC Ill., 1/13/61.

IRS won't apply rule on double accrual of state taxes to changes before September 14, 1961. The IRS held in *Rev. Rul.* 60-133 that the change of lien date by a taxing jurisdiction would not be considered as advancing the accrual date for deduction of the taxes so as to permit a deduction of more than 12 months' property taxes in one income tax year. Subsequently, the Code was amended, and Section 461 now contains a specific rule limiting such double accruals. The IRS now rules that it will not apply *Rev. Rul.* 60-133 if the change in the local law occurred prior to September 14, 1960, the date of the approval of the amendment to Section 461. *Rev. Rul.* 61-7.

Redemption notes were legal obligation; interest deductible. Promissory notes given by taxpayer-corporation in redemption of its own stock are held to have created a valid indebtedness. The Tax Court held that the redemption impaired the capital stock of the corporation, and under local law the corporation was prohibited from so using its funds. Since the notes were not legally enforceable, taxpayer could not deduct interest on them. This court reverses. Looking to the actual value of the assets, rather than their book value, the court finds that there was no capital impairment. *Mountain State Steel Foundries, Inc.,* CA-4, 11/7/60.

Lease commissions and fire insurance premiums must be spread over years involved. Commissions paid by a lessor to brokers for securing leases extending over a period of more than one year are capital in nature to be spread ratably over the term of the lease, whether the

lessor reports his income on the accrual or cash basis. Also, fire insurance premiums paid on a policy for a three-year term by a cash-basis taxpayer must be prorated over the life of the policy. *Herter,* TCM 1961-19.

Retubing a boiler a capital expense; paving a deductible repair. The expenditure of $2,000 for retubing a boiler on premises converted to a supermarket is a capital expenditure. On the other hand, the cost to take a hump out of a truck entrance, to replace part of the sidewalk at the entrance, and to resurface a portion of a parking area constitutes deductible repairs. *Almac's, Inc.,* TCM 1961-13.

Expenses for title search deductible, but not cost of title insurance. Taxpayers paid a title insurance company amounts for (1) determining whether local taxes were being paid on property in which they had an interest and (2) a title insurance policy. The court allows the first expenditure as an ordinary and necessary expense paid for the management, conservation, or maintenance of property held for the production of income but disallows the second, since it is a capital expenditure, which would be of benefit for an indefinite period. *Farwell,* 35 TC No. 54.

Short sellers must capitalize amounts paid in lieu of stock dividends on borrowed stock. When a short-seller of stock borrows the securities to make delivery on the short sale, he is obliged to pay the lender any dividends declared on the stock during the borrowing. Such payments have been ruled deductible. However, when a stock or liquidating dividend is declared on the borrowed stock and the borrower must pay the lender because of it, the payment is a capital item and is not deductible. *Rev. Rul.* 60-359.

Repairs to newly acquired ships must be capitalized. Taxpayer, a steamship company, purchased eight war-built vessels from the Maritime Administration. Before taking title to the ships, taxpayer expended $550,000 in repairs in order to put them in condition acceptable to the U. S. Coast Guard and the Maritime Commission. The cost of these repairs was allowed to taxpayers as an offset against the purchase price. Taxpayer claimed an ordinary deduction for the repairs. The Tax Court disallowed the deduction and held that the amount of repairs should be added to the cost of the vessels. Alternatively, the taxpayer argued in the Tax Court that the cost of the repairs should be fully depreciated in the current year on the ground that this would match cost against revenue, which argument the Tax Court rejected. This court affirms, in a *per curiam* opinion, for the reasons set forth in the decision by the Tax Court. *Bloomfield Steamship Co.,* CA-5, 1/23/61.

Installation of AC electrical system is a capital expenditure. Installing an alternating current electrical system in a 20-story loft building, built in 1912, is ruled to be a capital expenditure recoverable only through depreciation. Not only did the installation increase the actual value of the building, it also made the building more valuable to tenants engaged in light manufacturing, from whom a higher rental could be obtained. *Herter,* TCM 1961-19.

ACCOUNTING METHODS

IRS will sue for refunds of settlements inconsistent with Cannelton unless election is made. The IRS announces that it will bring suit for repayment of refunds made in prior years based on depletion of calcium carbonates and other minerals if the basis on which the settlement was made is inconsistent with the decision in *Cannelton Sewer Pipe* (364 U.S. 76), which fixed the point at which mining stops and manufacture begins, unless the taxpayer elects under Section 4 of Public Law 86-781. That election permits the taxpayer to use the old definition. *Rev. Rul.* 60-375.

Retailer didn't elect LIFO inventory relief. The taxpayer, a general department store, utilized the retail method of inventory valuation from 1942 to 1946. For 1942 taxpayer filed an election to use LIFO for 1942 through 1945 and computed taxes on the LIFO method in conjunction with the retail method. For 1946 taxpayer used LIFO because at that time the Commissioner was refusing to recognize the retail method in conjunction with LIFO as valid. Taxpayer liquidated part of its inventories in 1945 and 1946 and replaced them thereafter. In 1951 the taxpayer filed claims for refund for 1945 and 1946, wherein it applied for permission to have the relief provisions of Section 22(d)(6) of the 1939 Code applied to its LIFO inventory liquidations for those years. At no time did the taxpayer file with the Commissioner an application for an extension of time within which to elect to have the provisions of Section 22(d)(6) applied to its LIFO inventory liquidations for the taxable years 1945 or 1946. Claims for refund were disallowed, and the district court held that the taxpayer failed to file a timely election. This court upholds the decision of the district court. The filing of a claim for refund with the local Collector of Internal Revenue did not constitute a request or application for an extension of time to make an election required to be filed with the Commissioner. *L. S. Ayers and Co.,* CA-7, 12/29/60.

Use of arbitrary mark-down percentages to value inventory disapproved. A partnership in the business of selling house trailers arbitrarily marked down its cost inventories of new house trailers at the close of each year by flat percentages without regard to make, model, changes in shape, imperfections, or similar causes. It argued that the method should be approved because it had been consistently followed. The court finds that the evidence refutes rather than supports the proposition that the mark-downs reflected market values and shows that the formula followed in the valuing of the inventories did not clearly reflect income. Since it does not reflect income, little weight is to be given to consistency. The formula is disapproved. *Jones Estate,* TCM 1961-5.

Notes without ascertainable value excluded from income of cash-basis taxpayer. Taxpayer was engaged in the general brokerage business and reported on the cash basis. Unsecured and non-interest-bearing notes received by taxpayer in consideration for services rendered are held excludable from income when received, where the notes had no ascertainable value and later proved worthless. *LeVay,* TCM 1960-263.

Oklahoma tax accrues on January 1. In Oklahoma, ad valorem real estate taxes become a liability of the owner of the property on January 1 and a lien against the property on that date. The actual tax rate is fixed in April or May. Even though the amount is not then determinable, the court holds, affirming the district court, that the tax accrues for Federal income tax purposes on

January 1. *Oklahoma Natural Gas Co.*, CA-10, 12/21/60.

DEPRECIATION

Percentage depletion based on gross production disallowed to taxpayers with a net profit interest. Taxpayers, owners of an oil lease, assigned it to a corporation reserving an overriding oil royalty and 25% of all production after deduction for (1) the royalty to the original lessor, (2) the overriding royalties, (3) all taxes assessed against operation, (4) all drilling and development costs and operating expenses, and (5) a management cost of 5%. Taxpayers sought a percentage depletion deduction based on 25% of the gross production. The court finds that the 25% interest retained was a net profit interest and that taxpayers were not entitled to percentage depletion based on 25% of gross production. Taxpayers are also denied depletion losses on personal property taxes paid by the lessee, since it was not shown what taxes were imposed on taxpayers. *Farwell*, 35 TC No. 54.

Intangible asset group had continuing value; can't be depreciated. Taxpayer, a doctor-member of a health group, joined with other doctors in buying out their employer. The major assets purchased were the medical service contracts, which were prepaid by subscribers for six months. The contract of sale allocated no amount to these service contracts, either individually or as an aggregate. Taxpayer allocated the purchase price to each specific contract and wrote off this cost over the contract's remaining life. The court disallows the deduction on the ground that the acquisition was of a single capital asset, which had continuing value and useful life. Thus it could not be amortized. *Boe*, 35 TC No. 79.

Sea walls and drainage pumps to protect subsiding oil lands are capital costs. Taxpayer owned a tract of coastal land on which numerous oil wells have been drilled. The land has been subsiding, and sea walls, dikes, bulkheads, pumps, and drainage systems have been constructed to prevent inundation and seepage. The IRS rules that although repairs, maintenance, and moving costs occasioned by the subsidence are deductible, expenditures for sea walls, pumps, and drainage systems, the benefits of which are to be derived over more than one taxable year, must be capitalized and recovered through depreciation. The IRS distinguishes cases that have allowed the deduction as expenses of payments that did not extend the life of the property or even increase its value by pointing out that those involved extraordinary maintenance, whereas here entirely new structures are created to provide protection from future damage. *Rev. Rul.* 60-386.

Pre-1913 depreciation adjustment not affected by Chicago and North Western acquiescence. The fact that the IRS will follow *Chicago and North Western Railway* (29 TC 989) has no bearing on the pre-1913 adjustment required by reason of a taxpayer's change from the retirement method of depreciation accounting to another method. *Rev. Rul.* 60-390.

Cattle were segregated for breeding herd. Over 500 heifers were separated from cattle sold as livestock. The heifers were intended as additions to the breeding herd. Drought, however, caused taxpayer to change its plans, and it sold these heifers along with the others. The court finds that these heifers were bona fide breeding cattle and were not held for sale. It allows capital gain. *Coldwater Cattle Co.*, DC Tex., 1/9/61.

Devisee not allowed depreciation on inherited leased building. A tenant constructed a building on property leased from the taxpayer's mother. The mother died, bequeathing a life estate to the taxpayer in the property. The taxpayer sought to take depreciation on the building erected by the tenant. The Tax Court disallowed the depreciation deduction, and this court affirms. Basis alone is not sufficient to permit the allowance for depreciation; the taxpayer must have a depreciable interest in the building itself. Taxpayer simply acquired a life estate in real property subject to a long-term lease. In the alternative, the taxpayer argued that at the date of the decedent's death the rental provided in the lease was higher than the fair rental value of the land, that the valuation of the property was higher than the value of land subject to normal rentals, and that, therefore, she should be permitted to amortize these favorable features over the life of the lease. This court notes the conflict between the decisions of the Ninth Circuit in *Moore* (207 F.2d 265 (1953)) and the Seventh Circuit in *Friend* (119 F.2d 959(1941)) but skirts the issue by saying that, even if the court were to accept the taxpayer's theory that the alleged excess or premium rentals should be treated as a separable, depreciable, intangible asset, it is of the opinion that the evidence failed to establish the claim of the wasting or exhaustion thereof, and further, in the situation here any testimony offered in support of such claim could be found on nothing more than guess, speculation, and conjecture. *Schubert*, CA-4, 1/17/61.

Miscellaneous new decisions this month

Officers not guilty of willfully failing to collect and pay over withheld taxes. The president and secretary of a corporation were assessed a 100% penalty for failure to pay to the Service income tax withholdings and Social Security taxes on employees of the corporation. Each paid $50 and brought this suit for refund. The jury finds that the president and secretary did not "willfully" fail to pay over the taxes collected. [Few facts are reported; the instruction to the jury does not reveal the evidence on which lack of willfulness was based. — *Ed.*] *Steele*, DC Ark., 1/11/61.

Surety was not employer; not liable to withhold. During the period it was surety for a sub-contractor, taxpayer jointly signed a payroll check disbursed to the employees by the subcontractor. The court holds taxpayer was not an employer during this period. Withheld taxes and FICA taxes paid by taxpayer were refunded. *Century Indemnity Co.*, DC Calif., 12/5/60.

Part of sales price of animal raised on allotted land is tax-free. Upon the sale or exchange of animals raised by an Indian on allotted and restricted land, a part of the proceeds is exempt. The exemption is equal to the sum of the average per-head grazing fees charged on his reservation for each year that the animal grazed on his allotment. He may use a higher than the average fee if he can show that his allotment could have been leased for grazing at a higher fee. *Rev. Rul.* 60-377.

TAXATION OF

Estates, trusts & gifts

EDITED BY WILLIAM K. STEVENS, LL.B.

Ruling 60-227 clarifies income in respect of a decedent arising from property

by **WILLIAM P. SUTTER**

Rev. Rul. 60-227, although apparently only a routine application of the income-in-respect-of-a-decedent rules of Section 691, has particular importance when examined, as Mr. Sutter does here, in the light of the long succession of confusing cases dealing with the income and estate aspects of partnership interests. The Second Circuit in the Ellis case in 1959 brought earlier cases into consistent pattern and now, in Rev. Rul. 60-227, the IRS applies the same principles to royalties, promising at last a consistent and rational application of Section 691.

REV. RUL. 60-227,[1] stated to be a clarification of *Rev. Rul.* 57-554,[2] has cast further light on the question of what does and does not constitute "income in respect of a decedent"[3] and the proper income and estate tax treatment of items of that type.

Rev. Rul. 60-227 deals with a non-exclusive license of patents. The license was executed during the decedent's lifetime, and royalties were accrued at the date of his death. Further royalties arising from sales of the patented articles accrued after his death and were paid to his executor. The executor contended that both the royalties accrued at the date of the decedent's death and those arising from later sales were income in respect of a decedent and that the estate was entitled to a credit for estate taxes paid thereon. The Internal Revenue Service ruled, however, that only the royalties accrued at the decedent's death fell under IRC Section 691; the remainder were ordinary income to the estate under Section 61.

The ruling indicates that, for an item to constitute income in respect of a decedent, it must be an item of income to which the decedent was entitled in the sense that it was earned in his lifetime, although receipt or the determination of the amount was deferred or contingent. In this case, since a non-exclusive license was involved, the royalty income from sales after the decedent's death was not viewed as earned during his lifetime. There had not been an *inter-vivos* transfer of the decedent's rights in the patents. *Rev. Rul.* 57-544, which held that royalties arising from the sale of a copyright to a book were income in respect of a decedent, was distinguished because of the fact that it dealt with a sale as distinguished from a mere license.

Viewed in an objective light, *Rev. Rul.* 60-227 does not seem unusual. If it stands for the proposition that royalties on licensed patents must be treated the same as rent on leased property, it certainly is proper, since rent has never been considered as income in respect of a decedent but is ordinary income to the estate owning the leased property. It is also clear that, where a decedent owns property subject to a lease, it is the value of the property as a whole (including the value of the lease) that is included in the decedent's gross estate for estate tax purposes. In such a case, no income tax deduction is allowed for any estate tax paid on the asset, nor is the value of the lease depreciable separately from the leased asset. On the other hand, where a decedent does not own the leased property but simply holds a lease that is producing rents, the rents when received still do not constitute income in respect of a decedent, but the estate tax value of the lease may be amortized over the life of the lease.

These factors make it difficult to understand why the executor in *Rev. Rul.* 60-227 contended for the proposition that the royalties constituted income in respect of a decedent. If, for estate tax purposes, such royalties were taken into account in valuing the patents held by the decedent, as would seem to have been proper, then their value could have been recovered through amortization of the value of the patents over their remaining lives. If, improperly in my opinion, the license was valued as a separate asset of the estate, then its value would seem to be amortizable over its life. In the usual case either result would have been preferable to a deduction for estate taxes paid on income in respect of a decedent.

However, a possible explanation of this situation may be found in a survey of the numerous and inconsistent decisions involving contractual rights to partnership profits earned after death. Under IRC Section 736, payments in liquidation of a deceased partner's interest are considered as a distribution of partnership income if the amount thereof is determined with regard to the income of the partnership. Section 753 provides that such amounts "shall be considered income in respect of a decedent under section 691." Inasmuch as Section 691 gives a credit for estate tax paid on income in respect of a decedent, it is clearly implicit that such payments out of post-death partnership income must be valued and included in the decedent's gross estate.

Although the foregoing sections are new with the 1954 Code, they were foreshadowed by decisions under the 1939 Code. Back in 1935, *Bull* (295 U.S. 247, 1935) held that a right to share in partnership profits after death did not give rise to an asset includable in a decedent's gross estate but that the profits were ordinary income to the estate under Section 22(a). The concept of income in respect of a decedent did not then exist, Section 126 being first enacted in 1942. Since 1935, however, the *Bull* case has been whittled away, at least in the estate tax field, until it no longer casts much of a shadow.

Thus, in *George R. Nutter Estate* (46 BTA 35, 1942) *aff'd sub nom. McClennen* (131 F.2d 165, CA-1, 1942) the gross estate of a deceased member of a law partnership was held to include the value of a contract between the partners providing for payments of a percentage of net profits of the suc-

ceeding partnership for a period after death, as consideration for the deceased member's interest in capital, assets, receivables, possibilities, and good will of the firm. This contract was valued at $34,069.99, although the decedent's shares of capital account, plant account, and undistributed profits on the partnership books were only $1,031.25, $744.37, and $6,136.21.

Sale question stressed

The Board of Tax Appeals distinguished the *Bull* case as one involving a partnership where there was neither capital investment nor tangible assets, whereas the law partnership before it had both capital and tangible assets. Further, the Supreme Court in the *Bull* case stressed that the decedent had not sold his interest to the surviving partners, whereas here there was an "unambiguous provision for the 'sale' of the deceased partner's interest in the capital, assets, etc., in consideration of the percentage of net profits for 18 months." In other words, in the *Bull* case, the estate remained a partner, sharing in profits and losses, whereas here, the Board found, Nutter's estate was simply being paid off under a contract. This contract had value and was includable in the decedent's gross estate. At the same time, the Board indicated that the full partnership income in such a case would be taxable to the surviving partners, since the amounts paid to the estate were paid by them in purchase of a capital asset.[4] There was, of course, no income in respect of a decedent under the law then in effect.

The Court of Appeals for the First Circuit affirmed, stating that a deceased partner's representative obtains, on his death, a chose in action, "a right to receive in cash the sum of money shown to be due him upon a liquidation and accounting." This chose in action, it said, must be included in the gross estate. In the case before it *(McClennen)*, where a right to profit payments for a term certain was given in lieu of any interest in the partnership, the court had no doubt that "the substituted right to which the executor of the deceased partner succeeds must be included as a part of his gross estate." However, the court refused to go along with the Board's dictum as to the income tax treatment of the payments, saying, "We intimate no opinion as to the many perplexing income tax problems lurking in the background."

Although this case may be explained as holding only that the value of a deceased partner's partnership interest may be determined by reference to future payments, the circuit court also gave an illustration of a quite different situation. It stated that, if a partnership agreement provided that, on death, the partnership should continue for a limited term, the estate sharing in the profits during the term, subjecting its share of partnership assets to the risks of business, and on termination receiving its share of the then partnership assets, the chose in action includable in the deceased partner's gross estate would consist of "a right to a fixed share of the profits of the business during the continuance of the term, plus a right to receive in cash the amount due to A's estate upon a final liquidation and accounting after the expiration of the term." In such case, under *Bull* and in the view of the Board of Tax Appeals in *Nutter*, the right to share in income as a continuing partner for the duration of the partnership term would not be includable in the deceased partner's gross estate, as there would be no sale of a partnership interest, but the circuit court clearly felt differently.

Estate cases follow dicta

Then, in *Winkle* (160 F. Supp. 348, DC WD Pa., 1958) the precise situation hypothesized by the First Circuit in *McClennen* came before a district court. The partnership agreement provided that, on the death of a partner, the partnership would not terminate but would continue for its normal duration. During this period, the deceased partner's capital contribution was to remain liable for the risks of the business, and his estate was to share in the partnership profits. At the termination of the partnership, the decedent's estate would receive his share of the then partnership capital account. When income was received, the decedent's estate paid income tax thereon, apparently on the theory of *Bull* that the income constituted ordinary income of the estate as a continuing partner.

Relying principally upon the example given in *McClennen, supra*, the district court held that "the right of the estate here to a share of the post-death income of the partnership is properly includible in the gross estate of the decedent for estate tax purposes," although a sale of the decedent's partnership interest could hardly be found. Answering the estate's contention that it was improper to collect an estate tax on income that had been reported for income tax purposes, the court simply referred to 1939 IRC Section 126 as allowing a deduction for estate tax attributable to income in respect of a decedent, indicating that the section was applicable to the partnership income in question.

One other estate tax case involving post-death partnership profits should also be noted. In *Riegelman Estate* (253 F.2d 315, CA-2, 1958), a law partnership with no significant tangible property was involved. In lieu of any other payments, the deceased partner was entitled to his share of undistributed profits at the date of death, his share of profits arising from work done prior to his death, plus his share of profits arising from work done within a set period after his death. The court cited the *McClennen* decision and held that the right to profits from work done after death was includable in the decedent's gross estate. It buttressed this conclusion by reference to Section 126. Although the profits in question had not been earned during the decedent's lifetime, the court said they would constitute income in respect of a decedent because they "were the fruits of the man's professional activity during his lifetime; and this is so whether the payments are considered to be in the nature of additional compensation for services performed by him during his lifetime or are considered to be in lieu of the chose in action to which his estate would have succeeded in the absence of a specific agreement."

The foregoing decisions in the estate tax field indicate that it is unnecessary for a partnership agreement to provide for a sale of a deceased partner's interest in order to require inclusion in the decedent's gross estate of a right to future partnership income,[5] and the *Winkle* and *Riegelman* decisions also indicate that such income, when re-

[*William P. Sutter is a member of the Chicago law firm of Hopkins, Sutter, Owen, Mulroy & Wentz.*]

[1] 1960-25 IRB 13.
[2] 1957-2 CB 361.
[3] IRC Section 691; 1939 IRC Section 126.
[4] The Board cited, among others, *Pope*, 39 F.2d 420 (CA-1, 1930); *Hill*, 38 F.2d 165 (CA-1, 1930); *W. Frank Carter*, 36 BTA 60 (1937); *Bavier C. Miller Estate*, 38 BTA 487 (1938).
[5] See Mertens, *Law of Federal Gift and Estate Taxation* (1959), Section 14.29.

ceived, constitutes income in respect of a decedent. The income tax decisions, however, have hardly been consistent.

Income tax cases

Coates (7 TC 125, 1946) involved years when Section 126 was in effect, but no reference to income in respect of a decedent appears in the opinion. In that case, the partnership agreement in an accounting firm provided for payment to the estate of a deceased partner of a share in partnership earnings for five years after the death of a partner, in addition to payment to the estate of all undrawn earnings and the decedent's share of work in progress at the time of death. The Tax Court held that payments of income earned after the decedent's death were not includable in the partnership income of the surviving partners.

Stressing the fact that there was no investment in a capital account, little in the way of tangible assets, and no evidenced intention of a sale of the decedent's partnership interest to the surviving partners, the Tax Court stated:

"These payments were not made in liquidation of any capital interest of the deceased partner in the firm's assets. The only payments of this nature required upon the death of a partner were the payments on account of past earnings and work in process, here designated as the 'capital account.' In addition to these payments, the estate of a deceased partner was entitled to the payment of a share of post death earnings not in consideration of a sale of partnership assets on liquidation, but in consideration of mutual promises contained in the original partnership agreement having no relationship to such a sale. These payments arose out of and depended upon the contract and their character must be determined by its terms. The estate acquired, upon the death of the partner, a vested contractual right to a share of the earnings, as earnings, and this right was fortified by a power lodged in the trustee to require a liquidation of the business if its rights were not fully respected by the surviving partners. When and as the income was earned, it became immediately subject to the pre-existing rights of the estates to their share of it. The amounts so distributable to the estates were not distributable to any surviving partner, with the result that here, as in *Richard P. Hallowell, 2nd* . . . the disputed amount attributed by the respondent to each surviving partner may not be regarded as 'his distributive share, whether distributed or not, of the net income of the partnerships.' "

The Tax Court relied heavily upon the *Bull* decision and distinguished the *Nutter (McClennen)* case on the ground that there the partnership had invested capital and owned tangible personal property, and the intent of the contract was to effectuate a sale of the deceased partner's valuable capital interest in the partnership assets. Because, in the instant case, "there is no such intent to make a sale of a capital asset," the court held the payments to be income to the estate, not the surviving partner.

The *Coates* decision is consistent with that of the Board of Tax Appeals in *Nutter* but it does not square with the example given by the circuit court of appeals in affirming the Board's decision in that case or with the language of the *Winkle* and *Riegelman* opinions, in which little weight was given to the existence or non-existence of a sale.

Boyd C. Taylor Estate (17 TC 627, 1951, *aff'd per curiam*, 200 F.2d 561, CA-6, 1952) added further confusion to the situation. An insurance underwriting partnership was there before the Tax Court. Capital and tangible assets were of little importance. The partnership agreement provided that the deceased partner's estate was entitled to his share of accumulated profits and also to become a partner in a continuing partnership for a limited period. This latter right was included in the decedent's gross estate at $140,000, appropriately in the light of the later *Winkle* case.

Section 126 was in effect in the years in question but, as in *Coates*, was apparently ignored by all parties. The estate received partnership profits and took them into income, but it sought to deduct from such profits amortization of the estate tax value of the right to participate therein as would have been appropriate if the estate had owned a lease without owning the underlying property. The Tax Court found that the payments were not a purchase of the decedent's partnership interest. Then, referring to *Bull*, it said that, in order to allow amortization, it would have to hold that "this right held by petitioner constituted a capital asset which it received from the decedent." Because "the partnership was a personal service concern requiring no capital or tangible property and to which none of the partners had contributed capital," *Bull* was cited for the proposition that "the right inuring to petitioner to receive decedent's share of the partnership was not capital." Therefore, it was not subject to amortization.

Judge Kern dissented, pointing out that the right to share in income had been included in the decedent's gross estate, which, he felt, would not have been proper if *Bull* were applicable to the instant situation.

A few years after this holding, the Tax Court arrived at precisely the opposite result in *Howell* (24 TC 342, 1955), another decision notably silent as to the possible application of Section 126. The partnership involved had some capital and tangible assets, but the decedent's share thereof amounted to only $2,000. Under the partnership agreement, the decedent's share of such assets was to remain in the partnership until the end of its term, and the partnership was meanwhile to share in partnership income. The decedent's partnership interest was valued for estate tax purposes at $45,000. Both the taxpayer and the Commissioner agreed that inclusion of the right to future income in the decedent's gross estate was proper. At the same time, they agreed, and the Tax Court agreed with them, citing *Coates*, that the income, when received, constituted the income of the estate, not of the surviving partner. Under the *Coates* rationale this meant that there had been no sale of a partnership interest.

Nevertheless, the Tax Court upheld the right of the estate to amortize the $45,000 estate tax valuation over the life of the estate's right to share in partnership income. The ground for distinguishing *Taylor* and the *Bull* case was that the partnership here did have *some* contributed capital and did own *some* tangible property (total value, $4,556.30). The Tax Court said that the $45,000 figure was based "on a consideration of the adjusted value of the assets, earnings and other relevant factors," quoting from the Commissioner's deficiency letter. This, it said, "gave recognition to the fact that the partnership had employed capital and had in-

[6] *Cf. Black* v. *Lockhart*, 209 F.2d 308 (CA-8, 1954).
[7] See also *Edna S. Ullman*, 34 TC No. 114 (1960); *William F. Cooper Estate*, 19 TCM 521 (1960), both indicating that the basis sections are not applicable to income in respect of a decedent.
[8] *Linde*, 213 F.2d 1 (CA-9, 1954), *cert. denied*, 348 U.S. 871 (1954).
[9] See also *Rev. Rul.* 58-436, 1958-2 CB 366.

vested in and used the foregoing property in the conduct of its business. . . :

"The right of decedent's estate to share in the profits of the theatre business clearly was a valuable asset. The life of that asset was definitely limited to the period beginning with the decedent's death on March 6, 1947, and ending on May 2, 1950. For estate tax purposes the respondent has determined the value of the asset at $45,000. In the absence of evidence to the contrary, such value is deemed to have been its fair market value at the time of its acquisition by the estate and its basis for the purpose of exhaustion allowances."

Summary of older cases

Based upon the decisions discussed at some length above, a number of conflicting conclusions might have been drawn.

1. For estate tax purposes, a contractual right to share in future partnership profits is a part of a decedent's gross estate, whether or not arising from a sale.

2. For income tax reporting, according to *Winkle* and *Riegelman*, such profits, whether or not paid for a sale, give rise to income in respect of a decedent.

3. For income tax reporting, according to *Coates*, such payments are income to the estate if they are not payments of purchase price for the deceased partner's partnership interest; if they are, then they are taxable as income, not to the estate but to the purchasing partners.[6]

4. The estate tax value of a right to future partnership income may be amortized, where such income is taxable to the deceased partner's estate (there having been no sale), so long as the partnership had some contributed capital and some tangible property, even though its value is substantially less than the amount to be paid to the deceased partner's estate *(Howell);* if there is no tangible property, such estate tax value cannot be amortized *(Taylor).*

Finally, in *Ellis* (264 F.2d 325, CA-2, 1959) a clear-cut application of Section 126 to post-death partnership profits was at last required. In a partnership without invested capital and in which capital was not a substantial income-producing factor, the partnership agreement provided that a deceased partner's estate would be a "dormant partner" for 10 years. This right was included in the decedent's estate on audit of the estate tax return.

When the decedent's widow received payments of partnership profits, she contended that she was entitled to recover the full estate tax value before she had any taxable income. The Commissioner rejected this theory but allowed her to amortize the estate tax value of the right to share in post-death profits over a 10-year period. He thus adopted the *Howell* approach but in a case where there was no invested capital. Thereafter, the Commissioner took a second look and, evidently for the first time, concluded that amortization was improper, not on the theory of the *Taylor* case but because the payments received by the widow were income in respect of a decedent under Section 126.

The taxpayer argued that the concept of income in respect of a decedent is not applicable to payments that resulted from the partnership business subsequent to Ellis' death. However, stressing that "the right which decedent acquired had its source exclusively in the contract" and "this contract did not result from any bargain between the surviving partners and Ellis' estate but stemmed solely from Ellis' efforts and bargaining position during his lifetime," the court held that the income was income in respect of a decedent. The court cited its own opinion in *Riegelman* with approval. It concluded that "section 126 carries its own deduction provisions and provides for no depreciation allowance."[7]

To the extent that the *Ellis* decision laid to rest the concepts embodied in such earlier cases as *Coates, Taylor,* and *Howell,* it brought order into the area of post-death partnership profits. Under the line of estate tax decisions beginning with *McClennen,* a contractual right to such profits would be includable in a decedent's gross estate, and under *Winkle, Riegelman,* and *Ellis* such profits when received would constitute income in respect of a decedent with respect to which no amortization would be allowed but as to which a deduction for estate tax paid would be given. This approach coincides with that of Sections 736 and 753 of the 1954 Code. No reference to partnership capital, tangible property, or the sale of a partnership interest is required.

The difficulty with these partnership decisions was the fact that, in defining income in respect of a decedent taxable both for estate and income tax purposes, they laid great stress on the fact such income need not have been accrued at the date of death. Inasmuch as Section 126 was enacted largely to counteract *Enright Estate* (312 U.S. 636, 1941) and since that case dealt with partnership profits earned and thus accrued but not yet realized at the time of death, it was urged in *Riegelman* and other cases that Section 126 dealt only with such accrued income. The courts, however, held that this was not the case and that income in respect of a decedent may include income earned after death but "realized under and in consequence of contracts and deals made by the decedent in his lifetime."[8]

Other kinds of property

With this concept in mind, it might easily be concluded that any income arising after death as a result of a contract entered into by a decedent in his lifetime would constitute income in respect of a decedent. This could embody rents, royalties, interest, or what-have-you. True, the court of appeals in the *Ellis* decision referred to the "fallacy" of the argument that the partnership contract was to be treated "as if it were a coupon bond, a royalty contract, a leasehold, or a patent," and the partnership decisions also indicated that the courts were influenced by the fact that the payments were, in a sense, compensation for services rendered by the decedent during his lifetime. Nevertheless, such decisions, taken together with *Rev. Rul.* 57-544, which in no way stressed the fact that a sale of decedent's interest in the copyright had given rise to the royalty contract, left unclear the line between income in respect of a decedent and ordinary income to an estate. Thus, *Rev. Rul.* 60-227 has served a useful function in making clear that where income from property is concerned, Section 691 applies only where the asset has been disposed of during the decedent's lifetime, so that all which the decedent possesses at death is a contractual right to future income.[9] Where the asset itself is retained, no event prior to death can be said to have earned the future income. On the other hand, where compensation for services is concerned, such compensation must perforce have been earned before death. The line between these two areas may be difficult to observe at times, but the conceptual difference should be kept in mind. This is the real significance of *Rev. Rul.* 60-227. ☆

New estate & gift decisions this month

Gifts of trust certificates of indebtedness qualify for exclusion. Vose transferred real estate to trustees of the "Vose Family Trust." The trustees issued certificates of indebtedness to be paid out of the corpus of the trust upon its termination wih interest at 6% a year payable quarterly. The certificates could not be transferred without the written consent of the trustees. Vose adopted a practice of transferring certificates, each in the face amount of $5,000, to members of his family. In a probate court proceeding the certificates were held to be valid obligations of the trust and the transfers to be effective gifts. The Commissioner contended that the transfers were gifts of future interest, and the district court agreed with the Commissioner. On appeal the Court of Appeals for the First Circuit reversed, holding that the gifts of the certificates were outright gifts and qualified for the annual exclusion. *Vose,* CA-1, 12/1/60.

Life estate with right to use principal qualifies for marital deduction. Decedent's will gave his wife the "life use of all the rest, residue and remainder of my estate . . . with the right to use any part of the principal thereof." After the wife's death the residue was to go to certain children and grandchildren. In a proceeding to construe the will the surrogate's court held that the wife had an unlimited right to consume any and all of the principal, and in a suit for refund of estate tax the district court held that the power was sufficient to qualify the life estate for the marital deduction. In support of its decision the district court cited House Report No. 1027, 85th Congress, First Session, accompanying the Technical Amendments Act of 1958, which provides in part, "if the surviving spouse has, in addition to a life interest, the unrestricted right, in her sole discretion, to invade and use the property generally for her comfort, happiness and well-being such a power would meet the test prescribed . . . ." *Copeland Estate (Lincoln Rochester Trust Company, Ex.),* DC WD, N. Y., 10/18/60.

Contributions to college for fraternity house held deductible. Ordinarily a transfer to a social fraternity for the purposes of the fraternity would not be deductible, but the Commissioner has now ruled that transfers to a college for the purpose of acquiring or constructing a housing facility for a designated fraternity, title to which will be in the college, are deductible provided the following conditions are met: (1) The college has adopted a clearly defined policy of providing housing for all its students and, as part of this official policy, of improving and providing appropriate housing for all fraternity members. (2) The terms of the transfers and their acceptance make it clear that the designation of the gifts for improving or building a house for a designated fraternity in no way restricts or limits the full ownership rights of the college or future uses which the college may wish to make of the property. (3) The college retains and, presumably, will exercise discretion and control with respect to the amount spent on a fraternity house and with respect to its size, character, and architecture, which will be consistent with the standards and patterns of the college for other student houses and consistent with the house policy of the college. No part of the gift will be spent on improvements owned by anyone other than the college. (4) The policy of the college is that leases will be for short-term periods and rentals will be closely comparable to the rental as charged for comparable house facilities in the college dormitories. *Rev. Rul.* 60-367.

****Marital deduction not allowable for contingent portion of insurance proceeds.*** The proceeds of decedent's insurance policy were payable to his wife in equal monthly installments for life with 240 installments guaranteed. If she should die before receiving the 240 installments, his daughter was to receive the remainder, but if both his wife and daughter died before the 240 installments had been paid, the computed value of those unpaid was to be paid in one sum to the estate of the survivor. Of the total proceeds of $25,187, the insurer determined that $17,956 was necessary to fund the 240 payments to the wife, the daughter, or the estate of the survivor and $7,231 was necessary to fund the monthly payments to the wife so long as she might live beyond the 240 months. Decedent's executor included the value of the policy, $25,187, in the gross estate but claimed that a portion of the proceeds, $7,231, constituted a separate property qualifying for the marital deduction. The district court agreed with the executors, but the Court of Appeals for the Third Circuit reversed. The Supreme Court, with three Justices dissenting, affirmed the decision of the court of appeals. The majority of the Court reasoned that the policy itself constituted a single property, that the interest passing to the surviving spouse could terminate or fail, and since the daughter would possess or enjoy a part of the property in the event of the failure of the wife's interest, no part of the policy could qualify for the marital deduction. *Mayer,* U. S. Sup. Ct., 11/21/60.

Estate tax status of transfers in 1931 and 1932 clarified. Generally, a decedent's gross estate includes the value of any interest of which the decedent has made a transfer reserving the right to income for his life or the right, either alone or in conjunction with another, to designate the persons who are to enjoy the transfer of property or its income. Section 2036(b) limits the application of this general rule to transfers made after March 3, 1931, and restricts its application to certain transfers made between March 3, 1931, and June 7, 1932. The Treasury now clarifies this latter restriction by adding to the Estate Tax Regulations the phrase "except that, if the transfer was made before June 7, 1932, the right to designate must be retained by or reserved to the decedent alone." It is now clear that, if the transfer was made prior to June 7, 1932, a right to designate the persons who are to enjoy the transferred property or its income will result in taxability only if retained by the decedent alone. TD 6501.

Powers given widow over insurance deposit and trust held created during life of insured settlor. Upon maturity of an endowment policy, decedent's husband left the proceeds on deposit with the insurance company under a supplementary contract. Under the terms of this contract he was to receive interest for life, and thereafter interest went to his wife for life. The contract provided that he and, in the event of his death, his wife should have the right to withdraw the deposit in whole or in part at any time. On October 13, 1942, decedent's husband established a trust he could revoke or amend at any time dur-

ing his lifetime, and after his death his wife could revoke or amend the trust. The husband died in 1946 and his wife, the decedent, in 1947 released her right to withdraw the amount on deposit with the insurance company and her right to revoke the trust. She died in 1955. It is held that neither the deposit with the insurance company nor the trust is includable in her gross estate. Her powers over them were created prior to October 21, 1942, and the powers were not exercised. *Hubner,* CA-9, 12/7/60.

Michigan widow's support allowance qualifies for marital. The Probate Court of Wayne County, Michigan, ordered that decedent's widow be paid the sum of $1,000 a month out of the estate for her support and maintenance during the progress of the settlement of the estate, such allowance to begin as of the date of death of the decedent and to continue for up to one year. In compliance with the order, the executor paid the widow 12 monthly payments aggregating $12,000. The Commissioner disallowed the widow's allowance when claimed as part of the estate tax marital deduction,. The district court overruled the Commissioner, holding that under Michigan law the statutory widow's allowance payable in monthly installments for a period of one year is a vested and indefeasible interest that falls outside the "terminable interest" provision and qualifies for the marital deduction. *Reynolds,* DC ED Mich., 12/6/60.

★***Trasury bonds acceptable in payment of Federal estate taxes valued at par, not market.*** Decedent left a gross estate valued in excess of $5 million, and her executor filed an estate tax return reporting a net tax of more than $1,900,000. Included in the assets of the estate were U. S. Treasury bonds having par value of $475,000 at the date of her death but a market value $26,965 less than par on that date. These bonds had a redemption value of par if applied by the executor in payment of decedent's Federal estate tax. In the determination of the estate tax the bonds were valued at par. The executor sought recovery of $13,968 plus interest as the alleged overpayment of tax attributable to the Treasury bonds. The district court held that the bonds should have been valued at market price, but on appeal by the Government the court of appeals reversed, holding par rather than market to be the proper value. The court reasoned that market sales do not reflect the full value of such a bond to the estate of the particular holder whose death establishes the valuation date. Such a bond, said the court, "is clearly worth par in the hands of the decedent's executor." An important element in the value of an estate asset is the use to which it may be put. *Ellis Estate (Bankers Trust Co., Ex.),* CA-2, 12/12/60.

Allowance paid to Georgia widow qualifies for marital deduction. Decedent, a resident of Georgia, died in 1955. His widow appealed to the Court of Ordinary of Richmond County for a year's support from the estate, and $59,600 was duly set apart for her support and maintenance for a period of 12 months. It is held that the allowance qualifies for the marital deduction. The court reasoned that, once the allowance is made, title to the property set aside cannot be divested on the happening of any event, and the interest passing to the surviving spouse is not a terminable one within the meaning of Section 2056(b) of the 1954 Code. *Setze Estate (The First National Bank and Trust Company of Augusta, Ex.)* DC SD Ga., 11/3/60.

New decisions: income taxation of trusts

★***Trustee not taxed on capital gains held in corpus for beneficiaries in Great Britain.*** The question is whether or not a trustee of an *inter-vivos* trust, established under the laws of Connecticut, is exempt from taxes on capital gains realized by the trust and allocated to corpus; all of the trust beneficiaries are residents of the United Kingdom, not engaged in a trade or business in the United States. Based upon *American Trust Company* v. *Smyth* (247 F.2d 149, CA-9, 1957), this court rejects the Government's contention that the trust is a separate taxable entity under United States laws and holds the gains exempt from U. S. tax, since the individual beneficiaries who would feel the economic burden of the tax are entitled to the exemption provided by the treaty between the United States and the United Kingdom exempting residents of the United Kingdom from tax on capital gains. *Maximov,* DC N. Y., 1/4/61.

Trusts were valid partners. A jury found that trusts were valid members of a family partnership and that the arrangement was bona fide. The facts are not stated. *Kuney,* DC Wash., 11/23/60.

Trustees were mere custodians; income is taxed to real owners of stock. At issue is the question of whether income from securities purportedly held in a trust should be taxed to the beneficiary or to the grantors of the trust. The securities had been given in 1941 by parents to their adult son and daughter. The son and daughter then, as grantors, entered into separate agreements to set up trusts, using the securities as corpus and naming third parties as trustees. Each trust agreement recited that it constituted an irrevocable assignment to the mother of the grantor of all income from the stock and that neither the grantor nor the trustees were to have any interest in the income. Each agreement also provided that the trustees would have possession of the stock, but that it was to remain in the name of the grantor, and the grantor reserved the right to vote the stock. The trust was to terminate upon the death of the grantor's parents. The son delivered the stock to the trustees, but the daughter did not; she did execute a power of attorney so that the son could vote the stock. In 1954 the son modified his trust and gave the trustees the sole right to vote his stock and had his stock certificates transferred to the name of the trustees. The Commissioner charged the mother with all the income from the trusts during the years 1954 to 1956. The court, however, taxes the income to the son and daughter. The court holds that the assignment of the stocks by the son and daughter to the trusts did not create trusts, since the trustees had no trust functions but were merely custodians; they could not manage or vote the trust corpus. This assignment, under the rule of *Horst* (311 U.S. 112), was merely an assignment of the fruit of the tree without assignment of the tree. The income from the stock was, therefore, taxable to the son and the daughter, since they owned the stock. However, income earned after the son's transfer of his stock into the name of the trustee in 1954 would be taxable to the mother, since she then had an equitable interest in the stock. *Dunham,* 35 TC No. 76.

NEW DEVELOPMENTS IN

Fraud & negligence

EDITED BY HARRY GRAHAM BALTER, LL.B.

Banks ordinarily cooperate with IRS in tax examinations of customers

by **LEONARD BAILIN**

How do banks respond when a Revenue Agent asks for information about the account of one of their depositors? Mr. Bailin tells how banks in Los Angeles and in New York City answered when they were asked this question.

IN THESE COLUMNS in July I described the procedures used by the Internal Revenue Service in investigating a suspected fraud case, including the routine check of the banks in the neighborhood of the suspect's home and business. In my article, describing the typical but hypothetical case of a Dr. Smith, I said, "The banks produced the statements which showed sizeable deposits and large checks, suggesting that Dr. Smith was a man of more than moderate means."

This remark prompted the vice-president of a bank in Seattle, Washington, to write me that most banks he had observed "in the interest of public relations, require a summons from an examining Revenue Agent before disclosing information to the Internal Revenue Service. This summons is returnable in 10 days. It is similarly the practice of many banks to utilize the 10-day period to (1) develop the data requested, (2) forward a copy to the taxpayer under examination."

This letter caused me to wonder whether banks in various areas did follow a different policy, and as a result Harry Graham Balter, the editor of this department, and I decided to inquire among banks in our areas. Mr. Balter spoke to the chief legal officers of the three largest banking institutions in southern California, all of whom have numerous branches. He found no unanimity of practice among these banks.

Bank A said that if the credentials every IRS man carries in his pocket are submitted, no subpoena would be requested. This would be a useless gesture in view of the fact that the records would eventually have to be turned over and at a less convenient place. However, the bank will normally notify its customer before the records are actually turned over to the Agent.

Bank B would demand a subpoena to preserve good public and customer relations. However, the customer probably would not be notified officially before the records are turned over to the Agent, although as a practical matter, the depositor usually "finds out somehow."

Bank C would turn the records over then and there without the necessity of a subpoena if "pocket credentials" seem satisfactory. The depositor normally will not be notified, although there are exceptions based on whether the manager of the local bank knows the taxpayer, whether the depositor is "important," etc.

New York practice

Pursuing the New York end of our investigation, I spoke to various officers of two of the largest banks in the New York City area. All of the bank officers said that they were extremely willing and ready to cooperate with any reasonable request for information put to them by either the Special Agents or the Revenue Agents of the Internal Revenue Service. There was no standard procedure followed by the officers of the banks, and none of them had official instructions about these information requests. The handling of each request was at the discretion of each officer. Most of the officers indicated to me that they would be willing to supply any information requested by the Internal Revenue Service immediately upon request and without the production of a subpoena if this information could be supplied readily and without any great inconvenience to the bank. However, if the request was for voluminous records, for Recordak copies of checks, or for any records that would require some time or effort to produce, the officers would request a subpoena. The bank officers would then have the time needed for the production of the required records. However, some of the officers said that they would supply almost any information requested if the credentials of the Revenue Agent or of the Special Agent were in good order and the request seemed to be a valid one. These officers told me that they knew that the Internal Revenue Service employee could very readily obtain a subpoena if he desired one and that, therefore, it seemed unnecessary to ask for one.

There appeared to be no standard procedure on notifying customers. The consensus seemed to be that the bank officers would not notify their depositors of these requests. However, most of the officers were candid in stating to me that, if the depositor was a friend or close acquaintance or if the depositor was a particularly valued customer, then they might be inclined to telephone the depositor and advise him, off the record, that an investigation was in progress and that the Internal Revenue Service had made requests for information.

It can definitely be stated that it is not the official policy of either of these large banks to notify the depositor of an information request made by the Internal Revenue Service.

Revenue Agents and Special Agents are accustomed to receiving the utmost cooperation from the banks in the New York City area. Although some of the banks do ask for subpoenas, many of the banks will give any requested information without subpoesnas. The Special Agents have the power to write out a subpoena, on the spot, and to hand it to the bank officer making the request for one. The Revenue Agents do not have this power. They are required to return to their office and to fill out a request for the issuance of a subpoena; the request must be approved by their superior and signed by the person in the office authorized to sign subpoenas. They must then return to the bank with the subpoena. This procedure will usually entail a delay of several days. Therefore, many of the Revenue Agents carry with them a form letter of request for

[*Leonard Bailin, an attorney and CPA, has been a member of the Tax Fraud Group in the Upper Manhattan Division of the IRS. He is now in practice in New York City.*]

information, which they can present to the bank if the banks ask for a formal written request. This letter of request, although not a subpoena, is very often accepted by the banks, and the information requested is furnished as requested in the letter.

The Collection Officers of the Service very often have occasion to telephone banks and to make inquiries about taxpayers who are indebted to the Government. These Collection Officers have found that the banks are willing to give certain information over the telephone. Most banks will disclose names of their depositors and balances of cash in their accounts. Collection Officers are then able to prepare levies upon these accounts and serve these levies immediately.

Section 7602 of the Internal Revenue Code authorizes the Secretary of the Treasury or his delegates to examine any books, papers, records, or other data that may be relevant or material to any tax inquiry. It further authorizes the summoning or subpoenaing of any person having possession or knowledge of these books, papers, or records and it authorizes the taking of testimony of such person under oath, as may be relevant to such inquiry. Section 7604 of the Code outlines the jurisdiction of the district court in compelling such attendance, testimony, or production of books, papers, records, or other data. Section 7605 authorizes the Secretary or his delegates to fix the time and place for examination. However, this time shall be not less than 10 days from the date of the summons. Section 7210 sets forth the penalty for failure to comply with the summons of the Secretary or his delegate.

Apparently most of the bank officers are not directly familiar with these sections of the Internal Revenue Code; however, they do know that there is a law which states that the banks must comply with reasonable requests of the Internal Revenue Service. They also know that the Service can compel the banks to bring their records to some proper place required by the Secretary or his delegates. They realize that it is simpler to comply with a request made by a Special Agent or Revenue Agent right in the bank. The banks realize their legal responsibility for giving this information and for co-operating with the Government in its attempts at enforcing the tax laws of this country and apparently are more than willing to cooperate to the best of their ability. ☆

ABA rejects voluntary disclosure proposal

BY A VOTE of 104 to 81 the American Bar Association House of Delegates, at its February meeting in Chicago, rejected the resolution of the Taxation Section that Congress be asked to write a voluntary disclosure provision into the Code.

Dean Erwin N. Griswold urged the House of Delegates of the ABA to refer the matter back to the Section of Taxation for discussion with the newly appointed Treasury officials. He said he favored an administrative rule, one that could be applied at the discretion of the IRS, rather than a provision in the Code. The language of the amendment recommended by the Section of Taxation might, he said, permit the escape of fraudulent taxpayers not intended to be covered. The House of Delegates, upon Dean Griswold's motion, referred the matter back to the Section.

The American Institute of CPAs, so recently as February 28, 1961, has also recommended a voluntary disclosure provision.

So far, all efforts to obtain such a provision have failed. ☆

New fraud and negligence decisions

Failure to file return due to accountant's sickness is not reasonable cause; computation of penalty. Taxpayer failed to file timely returns for the years 1951 to 1954 because its accountant, who was also a stockholder of taxpayer, was in poor health; tentative understated returns for those years were filed on September 15 of the respective years. Taxpayer's officers and directors, however, were aware that the returns were overdue, and the final returns for all the years in question were finally filed in 1955. The court sustains additions to the tax both for failure to file a timely return (finding no reasonable cause for failure to file) and for negligence or intentional disregard of rules and regulations but without intent to defraud. The court computes the additions to the tax without deducting the tax shown on the final return, the delinquent return, or the amount assessed each year, since the phrase "total deficiency" on which the additions are computed means the difference between the tax liability and the amount shown on the original return due at the time provided by law. *Robinson's Dairy,* 35 TC No. 64.

Income of actual owner of a slaughter house reconstructed by net worth. Taxpayer's income from a slaughter house is reconstructed by net worth statements after a finding that he was its actual owner and operator. A purported "lease" of the property and "sale" of the business were held to be sham transactions. The court also finds that taxpayer was a partner in a packing house during each of the taxable years. At least part of the deficiencies are considered due to fraud with intent to evade tax, so that none of the deficiencies are barred by any statutory limitations. *Roberson,* TCM 1961-1.

Underestimation penalty applicable if estimates are untimely filed. Where declarations of estimated tax were filed in proper amounts, but the returns were filed belatedly, the Commissioner could assert the penalties for substantial underestimation under Section 294(d)(2). *Jones Estate,* TCM 1961-5.

Income of small retail grocer reconstructed by percentage markup. The Commissioner is held justified in reconstructing sales of a small retail grocer by the percentage markup method where the books and records were inadequate. However, the court finds the Commissioner's percentage too high and accordingly redetermines the gross sales. *Seagraves,* TCM 1961-7.

Receipt of unreported kickbacks basis for fraud penalty. Fraud penalties are upheld where it was shown that taxpayer engineered a plan whereby suppliers to businesses he controlled made kickbacks to him through assorted conduits. Taxpayer never reported these kickbacks as income. These camouflaged transactions were considered in conjunction with taxpayer's conviction in a criminal fraud action on a *nolo contendere* plea for one of the years in issue. *Kisting,* TCM 1961-3.

TAX PROBLEMS OF

Corporations, stockholders

EDITED BY RICHARD L. GREENE, LL.B.

CA-9 says boot makes B reorganization impossible; Turnbow conflicts with CA-7

by **BURTON W. KANTER**

Does the Code definition of a stock-for-stock reorganization as being solely for stock mean just that? Or does the boot exception apply to the definition? When the Tax Court in Turnbow held last year that a stock-plus-cash exchange for stock did qualify as a B reorganization because the boot provision acted to modify the definition, tax men everywhere wondered whether a new and highly attractive type of tax-free exchange was being approved. Mr. Kanter believes the Ninth Circuit was correct in reversing and, examining the legislative history, concludes that, if the issue comes before the Supreme Court because of the conflict of the circuits, Turnbow will probably be upheld.

IT IS RATHER STRANGE that basic well-accepted concepts in tax law often go unchallenged for many years before the issue is raised squarely and given to the courts to decide. The principle that no consideration other than voting stock may be given in a stock-for-stock acquisition if it is to qualify as a B reorganization falls in this category.[1]

The Ninth Circuit reversal of the Tax Court decision in *Grover D. Turnbow* (32 TC No. 57, 1959, *rev'd* CA-9, 12/5/60) for the first time puts this rule squarely in conflict between two courts of appeals (*Howard*, CA-7, 1956, 238 F.2d 933, *rev'g* 24 TC 792, 1955) and may now be presented to the Supreme Court for consideration, 27 years after the statutory provisions giving rise to the issue were first adopted in 1934.[2]

The sections involved

Briefly, the statutory complex is as follows: The general rule that gain realized on the exchange of property is recognized except as otherwise provided is set forth in Section 112(a)(Section 1002 of the 1954 Code). Section 112(b)(3) (Section 354(a)(1) of the 1954 Code) provides that no gain or loss will be recognized if an exchange of stock or securities in a corporation, a party to a reorganization, in pursuance of a plan of reorganization, is solely for stock or securities in such a corporation or in another corporation a party to a reorganization. Section 112(c)(1) (Section 356(a)(1) of the 1954 Code, which contains some minor language differences) provides further that, if the exchange would have qualified under Section 112(b)(3) but for the receipt of cash or property (boot) other than the permissible stock or securities, then the gain will not be recognized in full but will be recognized only in an amount not in excess of the boot.

The B reorganization is defined in the 1939 Code in Section 112(g)(1)(B) as "the acquisition by one corporation, in exchange solely for all or part of its voting stock, of at least 80 per centum of the total number of shares of all other classes of stock of another corporation. . . ." The concept of the B reorganization remains essentially unchanged under the 1954 Code, though it is somewhat differently defined. Section 368(a)(1)(B) of the 1954 Code defines the B reorganization as "the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition). . . ." Control is defined in Section 368(c) as "the ownership of stock possessing at least 80 per cent of the total combined voting power of all classes of stock entitled to vote and at least 80 per cent

[1] It has long been assumed that this was the rule. See e.g. 3 Mertens, *Law of Federal Income Taxation* (rev.) Section 20.147, fn. 84a; Bittker, *Federal Income Taxation of Corporations and Shareholders*, Section 12.08; Rabkin and Johnson, *Federal Income Gift and Estate Taxation*, Section 31.04, 32.02: Cohen, Surrey, Tarleau and Warren, "A Technical Revision of the Federal Income Tax Treatment of Corporate Distributions to Shareholders," 52 *Col. L. Rev.* (1952); *A.L.I. Federal Income Tax Statute Tentative Draft 7*, at 338-340 (1952); Cohen, Silverman, Jr., Surrey, Tarleau, and Warren, "The Internal Revenue Code 1954: Corporate Distributions, Organizations and Reorganizations," 68 *Harv. L. Rev.* 393 (1955); Darrell, "The Use of Reorganization Techniques and Corporate Acquisitions," 70 *Harv. L. Rev.* 1183 (1957); Leake, "Problems in Corporate Acquisitions," 13 *Tax. L. Rev.* 67 (1957); Donnelly, "Courts Wrongly Permit Boot in Old-Law Reorganizations," 11 JTAX 138 (1959); Note, "Recognition of Gain Limited to Cash Received Which Barred Reorganization Characteristics," 57 *Col. L. Rev.* 591 (1957); Kanter, "The Changing Complexion of the 'B' Reorganization," 56 *A.B.A.J.* 1317 (1959), Note, "Reorganization—'B' Reorganization Exists Though Boot is Received," 73 *Harv. L. Rev.* 1402 (1960).

[2] The issue grows out of adoption in the 1934 Revenue Act of the concept that a stock-for-stock or a stock-for-asset acquisition must be accomplished "solely for voting stock" to qualify as a reorganization. Prior to 1934, the applicable reorganization definition was contained in Section 112(i) of the Revenue Act of 1932 and was defined as "a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation)." The Revenue Act of 1934 did not separate the definitions of a stock-for-stock and a stock-for-assets reorganization, the reorganizations now commonly known as the B and C reorganizations, but defined both under the same provision. The separation of the two clauses into the B and C reorganization definitions first occurred in the 1939 Code in Sections 112(g)(1)(B) and 112(g)(1)(C). The Revenue Act of 1934 moved the reorganization definition to Section 112(g)(1) and discarded the parenthetical language, substituting therefor the following: "the acquisition by one corporation in exchange solely for . . . its voting stock; of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation; or of substantially all the properties of another corporation. . . ."

[3] 1939 Code Section 112(c)(1) provides that "If an exchange would be within the provisions of subsection (b)(1), (2), (3), or (5), or within the provisions of subsection (1), of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph or by subsection (1) to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property."

[4] Discussed in text *infra*.

[5] The Court of Appeals for the Ninth Circuit did not discuss the *Bonham* case. This may have been because the Board did not have before it the precise issue presented in *Turnbow*. A careful analysis of the Board opinion, however, would seem to

of the total number of shares of all other classes of stock of the corporation."

CA-9 in conflict with CA-7

In 1952, the taxpayer in *Turnbow* exchanged all of the stock of his company for voting common stock of a national dairy company, and in addition received $3 million in cash. The stock of the national dairy company received by the taxpayer had a fair market value of $1,235,625, or approximately 29% of the total consideration taxpayer received for the stock of his company. The Commissioner determined that the taxpayer's full gain on the transaction was to be recognized on the ground that the transaction did not qualify as a tax-free exchange, since there was no B reorganization under the statutory definition, the exchange not being solely for stock of the acquiring corporation.

The Tax Court, however, held that the boot provision of Section 112(c)(1)[3] modifies both the provision of Section 112(b)(3) exempting reorganization exchanges from tax *and* the reorganization definition provision of Section 112(g)(1)(B), so that, despite the receipt by taxpayer of cash as well as qualified stock, the transaction constituted a reorganization and taxpayer's realized gain was to be recognized only to the extent of the cash boot received in accordance with the boot provision rather than in full. This resulted in a substantially smaller tax. The Tax Court based its conclusion primarily on the decision of the Seventh Circuit in *Howard*,[4] and partly on an interpretation of an earlier Board of Tax Appeals case, *Luther Bonham* (33 BTA 1100, 1936)[5] and certain Treasury regulations.[6]

The Ninth Circuit has now reversed the Tax Court in *Turnbow* and the holding appears to be squarely in conflict with the earlier holding of the Seventh Circuit in *Howard*.

In *Howard* 80.19% of the stock of one corporation was acquired from various stockholders in exchange for stock of another corporation. Additional shares were acquired from other stockholders for cash. With one exception, each stockholder received either all cash or all stock for his stock. The Tax Court concluded that, because of the cash payment involved in the transaction, the *solely* requirement in the reorganization definition of Section 112(g)(1)(B) was not met and the exchanges involved were not tax-free under Section 112(b)(3).

The Seventh Circuit Court of Appeals said that it agreed with the Tax Court in its analysis up to this point but that it could not go so far as to accept the Commissioner's contention that "there must be a qualifying reorganization within the meaning of §112(g)(1)(B) . . . before §112(c)(1) [the boot provision] can come into play." It held that the boot provision was applicable, since but for the cash received "the transaction would have met the 'solely' requirement of §112(g)(1)(B) [the reorganization definition] and fallen within the scope of §112(b)(3) [exempting exchanges from tax]."

This conclusion is clearly in conflict with the holding of the Ninth Circuit in *Turnbow*[7] that "the existence of boot prevents §112(g)(1)(B) from applying," and "since no reorganization exists, §112(b)(3) cannot apply" and "§112(c) is then also inapplicable."

Reasoning of Ninth Circuit

The Ninth Circuit grounds its *Turnbow* conclusion mainly on three points:

1. *Analysis of the legislative history of adoption of the solely-for-voting-stock concept in the 1934 Revenue Act definition of the B (and also the C) reorganization indicates that Congress intended to prevent the casting of a transaction which was in reality a sale into a form technically qualifying as a reorganization. This objective would be frustrated if the Tax Court view of the applicability of the boot provision were accepted so that cash could be received in addition to qualified stock.*[8]

support the Commissioner rather than the taxpayer.

In *Bonham*, the taxpayer agreed to transfer 750 shares of the First National Bank of Fairbury to the Northwest Bancorporation in exchange for 1,500 shares of Northwest stock, plus $67,500 in cash. The Fairbury National Bank had outstanding 1,000 shares of capital stock.

The then applicable definition of reorganization did not include the word "solely" and was simply the acquisition of at least a majority of the voting stock and at least a majority of the total number of shares of all classes of stock in another corporation. The Board held that the transaction involved having first qualified within the then definition of a reorganization the applicability of the taxing provision of Section 112(c)(1) was determined by whether or not the exchange in pursuance of a reorganization would have fallen within the tax-free treatment rule of Section 112(b)(3) were it not for the receipt of cash as well as stock. The Board did not decide that the reorganization definition and the operative taxing provision under Section 112(b)(3) were both modified by Section 112(c)(1). And in fact this precise issue could not arise then because the presence of the cash in *Bonham* was not considered to affect qualification of the transaction as a reorganization under the then applicable definition.

It is interesting to note that the Tax Court in *Turnbow* did not discuss the Board opinion in *Robert A. Pulfer* (43 BTA 677, 1941), which was cited earlier by the Tax Court in the *Howard* case. In *Pulfer*, Pratt Corporation by virtue of an acquisition of 556 shares of stock in Dibble Corporation for 3,336 shares of its own stock, when added to 1,220 shares of Dibble stock already held, became the owner of all of the outstanding stock of Dibble. In the absence of proof that Pratt's original holdings of Dibble stock had not been acquired for cash, the Board of Tax Appeals held that the exchange did not qualify as one of stock solely for all or a part of the acquiring corporation's voting stock under Sections 112(b)(3) and 112(g)(1)(B). Ignoring this opinion and relying on the *Bonham* case seems somewhat strange, considering that *Bonham* was decided more than five years earlier than the *Pulfer* case.

[6] The Tax Court relied on Regulations 118, Section 39.112(g)-4, in particular, the example contained therein as follows: "*Example.* A, in connection with a reorganization, in 1952, exchanges a share of stock in the X Corporation purchased in 1929 at a cost of $100.00 for a share of stock of the Y Corporation (a party to the reorganization), which has a fair market value of $90, plus $20 in cash. The gain from the transaction is $10 and is recognized and taxed as a gain from the exchange of property. . . ." This example, however, was probably intended to cover a merger or consolidation situation.

[7] The Seventh Circuit in *Howard* tries to treat its decision as one which gives effect to the "solely" concept in the reorganization definition, restricting its holding that Section 112(c)(1) is applicable, to modifying Section 112(b)(3)—the operative taxing provision—and not the definition provision of Section 112(g)(1)(B). It is rather difficult to understand what semantical concept the court of appeals had in mind, however, when the effect of modifying Section 112(b)(3) by Section 112(c)(1) must, in the light of the court's agreement with the Tax Court as to the meaning of the B reorganization definition, be in effect a modification of the reorganization definition. However, see text *infra*.

[8] What constitutes a sale and what should qualify as a tax-free reorganization transaction is still the basic problem with which everyone considering revision of the reorganization definition struggles. E.g., see: Statement of Crane Hauser on behalf of the Committee on Federal Taxation of the Chicago Bar Association, House Ways and Means Committee Hearing on Advisory Group Recommendations on Subchapters C, J, and K, February-March 1959, at p. 773, stating: "When nonstock consideration of 33⅓ per cent is present in an exchange or when the shareholders of a transferor corporation own only 50 per cent of its successor, we think that the transaction resembles a sale, rather than a mere continuation of the business in another form." Peterson, "Corporate Distributions and Adjustments: A General Survey," *House Ways and Means Committee Tax Revision Compendium* (1959), pages 1611, 1615, where it is stated: ". . . it is a question of . . . how far we can go before we come to what would generally be regarded as a sale." Surrey, "Income Tax Problems of Corporations and Shareholders: American Law Institute Project—American Bar Association Committee Study on Legislative Revision," 14 *Tax L. Rev.* 120 (1958), stating: ". . . some rationale is needed if a line is to be drawn between those exchanges to be treated as taxable sales and those in which recognition of gain is to be postponed." See also, Brown, "An Approach To Subchapter C," *House Ways and Means Committee Tax Revision Compendium* (1959), pages 1619, 1622, where it is stated ". . . the continuing legislative choice [is] whether the provisions for tax-free exchanges should be broad or narrow in scope."

[Burton W. Kanter, co-editor of THE JOURNAL OF TAXATION *"Shop talk" column, was formerly attorney-adviser to the Tax Court of the United States and is presently in law practice with the Law Offices of David Altman in Chicago.]*

Briefly, the situation in 1934 was that the reorganization provisions then applicable had been in existence in substantially the same form from 1924, but there had been developed various techniques for avoiding their impact by arranging what was in reality a sale to technically qualify in form as a reorganization. Correspondence from the then Secretary of the Treasury published in the Congressional Record,[9] as well as reports of the House Ways and Means Committee[10] and the Senate Finance Committee,[11] indicate that revision of the reorganization definition[12] to require that the consideration which may be given be solely voting stock aimed at eliminating *any* possibility of taxpayers arranging consummation of sales in the technical form of reorganizations. Since this was the only change made in the reorganization sections, and no other provision in the statutory structure was changed, the Ninth Circuit concluded that Congress could not have intended to correct the abuse which existed and simultaneously to permit this objective to be immediately frustrated by existing provisions of Section 112(c), as would be the effect of the Tax Court decision in *Turnbow*.

[9] 78 Cong. Rec. 2512 (1934).

[10] H. Rep. No. 704, 73rd Cong. 2nd Sess. 13 (1934). See also, H. Rep. December 4, 1933, 73rd Cong. 2nd Sess. 8-9.

[11] S. Rep. No. 558, 73rd Cong. 2nd Sess. 16 (1934).

[12] See note 2, *supra*.

[13] In *Hendler* (303 U.S. 564, 1938) it was held that the exchange in a C reorganization was not solely for voting stock where the acquiring corporation in addition to giving its voting stock assumed the liabilities of the transferor. See Surrey, "Assumption of Indebtedness in Tax-Free Exchanges," 50 *Yale L. J.* 1 (1940). See also *Stoddard* (CA-2, 1944, 141 F.2d 76), where the acquiring corporation not only assumed an unsecured liability, but the corporation being acquired changed the nature of the liability by converting it into a bond secured by a second mortgage on corporate property. It was held that the giving of the security to the unsecured creditor constituted the giving of consideration in addition to voting stock and that the exchange, therefore, was not solely for voting stock.

The definition of a C reorganization was amended in the 1939 Code by adding the following: "but in determining whether the exchange is solely for voting stock, the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded." See Rep. No. 855, 76th Cong. 1st Sess. pp. 18-20; S. Rep. No. 648, 76th Cong. 1st Sess. p. 3.

2. Congressional action in modifying the C reorganization definition under the 1939 and 1954 Codes indicates a belief by Congress that any consideration other than voting stock or in addition to voting stock will destroy the reorganization.

The B (stock-for-stock) and the C (stock-for-assets) reorganizations were part of a single definition under the 1934 Revenue Act. In both instances the exchange had to be solely for stock. In order to permit the acquisition of properties subject to a liability, in the case of a stock-for-assets acquisition, Congress found it necessary in the 1939 Code to avoid the *solely* requirement by specifically modifying the definition to provide that, in determining whether the exchange was *solely* for stock, assumption of a liability or acquisition of property subject to a liability should be ignored.[13] Under the 1954 Code, Congress modified the C reorganization definition to permit up to 20% of the consideration received to be other than voting stock without disqualifying the reorganization.[14]

The Ninth Circuit concluded that, since Congress thought it was necessary to make these specific amendments under both the 1939 and 1954 Codes in order to avoid the solely-for-stock requirement and to permit boot, Congress obviously felt that the rule, absent the amendments, was that there could be nothing given as part of the consideration other than qualified stock, if the exchange was to qualify as a reorganization. Since no change was made in these respects in either the 1939 Code or the 1954 Code as to the B reorganization, clearly no boot could be permitted in a B reorganization.

3. Despite the fact that failure to permit boot would allow taxpayers to arrange transactions to include boot to force recognition of losses, Congress did not intend to permit boot in a reorganization and permit taxation of gain under Section 112(c), since this would have frustrated its clear purpose to prevent sales being cast as reorganizations, even if reorganization might be cast as sales to obtain loss recognition.

Taxpayer argued a point accepted by the court of appeals in the *Howard* case, to the effect that, if boot were not permitted and taxation of gain limited under Section 112(c)(1), then what should really be recognized as a reorganization could be converted into a sale by payment of a small amount of cash and recognition of any loss thereby be obtained under Section 112(e).[15] Since the language of Section 112(e) and Section 112(c)(1) is virtually identical, taxpayer would, as was stated in *Howard*, have Section 112(e) and Section 112(c)(1) "applied in identical fashion depending on whether a loss or gain was involved." The Ninth Circuit, however, took the position that Congress in 1934 recognized the danger of tax avoidance through securing recognition of losses under Section 112(e) but felt for various reasons that there was a greater probability of attempting to cast sales

[14] Section 368(a)(2)(B) provides under the title "Additional Consideration in Certain Paragraph (1)(C) Cases," that a C reorganization will nonetheless exist if substantially all of the properties of another corporation are acquired for the voting stock of the acquiring corporation if the transaction would have so qualified but for the fact that money or property in addition to voting stock was given as part of the consideration, provided the acquiring corporation "acquires solely for voting stock" property of the other corporation "having a fair market value which is at least 80 per cent of the fair market value of all of the property of the other corporation." The provision for ignoring an assumption of a liability, or the acquisition of property subject to a liability, is modified for the purpose of computing whether or not 80% of the fair market value of all of the property of the corporation has been acquired solely for voting stock, so that for this purpose the liability is treated as money paid for the property.

[15] *"Loss from exchanges not solely in kind.* If an exchange would be within the provisions of subsection (b)(1) to (5) inclusive, or (10), or within the provisions of subsection (1) of this section, if it were not for the fact that the property received in exchange consisted not only of property permitted by such paragraph to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized."

[16] The Ninth Circuit points out that to its mind Congress decided that the danger of tax avoidance through specially arranged securing of recognition of losses, notwithstanding that a continuity of interest might exist, (1) would be avoided in numerous instances by reason of qualification of the reorganization under other provisions of Section 112(b)(1); (2) that it was the judgment of Congress reflected in hearings before the House Committee on Ways and Means on the 1934 Revenue Bill (73rd Cong. 2d Sess., p. 60 (1934), and H. Rep. December 4, 1933, 73rd Cong. 2d Sess. p. 34-42 (1933) Section 112(e) was not particularly effective in preventing taking losses; and (3) that if losses were taken, by reason of a particular arrangement of the transaction, the loss being from a sale or exchange of stocks or bonds, it would be limited to a large extent to gains from such sales or exchanges, so that, even if recognized, it could not be untilized by taxpayers. The Ninth Circuit concluded, therefore, that Congress "would seem to have weighed the desirable features of the proposed amendment (as to gains) against its undesirable potentialities (as to losses)" in making its determination to introduce the "solely for stock" concept as the technique for preventing nonrecognition of gains while not solving the problem with respect to arranged recognition of losses, and it would not substitute its judgment for the judgment of Congress in this regard. It should also be noted that in 1934 the House Subcommittee on Internal Revenue Taxation took cognizance of the fact that all of the then existing forms of

as reorganizations to limit recognition of gain and intended to preclude this possibility despite any undesirable potentiality for planned realization of losses.[16]

Continuity-of-interest not applied

It may be significant in future reorganization cases that the court of appeals in *Turnbow* ruled specifically on the question of whether or not there could be boot in a B reorganization. In doing so, the court apparently determined not to avoid a conflict with the Seventh Circuit by overruling the Tax Court in this case on the basis of its particular facts.

More than 70% of the consideration received by the taxpayer in *Turnbow* was cash. On the basis of this fact, it might have been possible for the court to rule that regardless of whether Section 112(c)(1) might otherwise be applicable in some circumstances to a B reorganization, this particular transaction was so much more like a sale than a reorganization that it should not qualify as a reorganization. Such a ruling could have been grounded on the judicially developed continuity-of-interest doctrine, which is generally applied with respect to A reorganization mergers and consolidations.[17] It is true that the 80% solely-for-stock rule in the statutory definition has been thought to be the applicable continuity-of-interest rule in B reorganization situations, and it is considered to constitute a more stringent continuity-of-interest rule than that imposed by the courts.[18] But in a case such as *Turnbow*, the issue could perhaps have been posed as whether or not the generally imposed court rule of continuity of interest could nonetheless be applied to preclude treatment of the transaction as a reorganization.[19]

If the court had held that the doctrine applied and that the taxpayer had not retained the requisite continuity of interest, the holding would still have been consistent with the tax treatment of other economically similar reorganizations. The Tax Court decision in *Turnbow* and the court of appeals decision in *Howard*, on the other hand, if applied consistently, would give rise to tax treatment of a transaction failing to qualify as a statutory merger under the A type of reorganization different from the tax treatment of a transaction which failed to qualify as either a B or a C reorganization (often called the practical mergers).

If a statutory merger transaction involves sufficient cash to take it out of the category of a qualifying reorganization because of failure to meet the judicially imposed continuity-of-interest test, the transaction will be taxable in full and the gain will be subject only to a capital gains tax under Section 112(a)—the transaction would not fall under the boot provisions of Section 112(c)(1).[20] Under the court of appeals *Howard* and the Tax Court *Turnbow* decisions, however, by saying that, even though cash constituted part of the consideration, there is, nevertheless, in all cases a reorganization, and the boot provisions apply, gain will be recognized only to the extent of the boot. The taxable gain under Section 112(c)(1) will usually be less than if the transaction had taken the form of a merger and failed to qualify as a reorganization;[21] but if the boot were taxable as a dividend,[22] then the tax treatment might be harsher than if the transaction had been in the form of a merger which failed to qualify as a reorganization. Thus, if the same amount of stock and cash were given as part of the consideration, different tax treatment could result with respect to economically similar transactions, depending on which (reorganization) form was selected for the transaction.

Statutory analysis

The effect of the decisions of the Tax Court in *Howard* and the court of appeals in *Turnbow* is that Section 112(c)(1) (the boot provision) must become inoperative in the case of a B (and C) reorganization. On the other hand, the effect of the decisions of the court of appeals in *Howard* and the Tax Court in *Turnbow* is that Section 112(a) (the general rule) must become inoperative. This is highlighted most clearly by the *Turnbow* case, where more than 70% of the consideration received was cash. The logical effect of the Tax Court decision in *Turnbow* is that, whenever a

reorganization permitted arbitrary recognition of losses by the taxpayer's own deliberate act in failing to comply with the provisions for nonrecognition, yet no changes were proposed to correct this abuse. See Hearings on Revenue Revision before the House Committee on Ways and Means, 73rd Cong. 2d Sess. 60 (1934). This type of formalism which permits taxpayers to unilaterally determine the tax consequence of a transaction occurs in other areas as well. For example Section 112(b)(6) of the 1939 Code could be avoided by a parent corporation liquidating a subsidiary in which it owned at least 80 per cent of the stock at the conception of the plan of liquidation, subsequently deliberating disposing of a small amount of stock. See *Avco Manufacturing Corp.* (25 TC 975, 1956); *Granite Trust Co.* (238 F.2d 670, CA-1, 1956).

[17] The continuity-of-interest doctrine is the result of *Le Tulle* v. *Scofield* (308 U.S. 415, 1940); *Pinellas Ice and Cold Storage Co.* (287 U.S. 462, 1933); *Cortland Specialty Co.* (60 F.2d 937, CA-2, 1932). For a recent extensive discussion of this doctrine also see *Berner* (Ct. Cls. 10/5/60).

[18] See Paul, *Studies in Federal Taxation* (Third Series), pages 36-41. The continuity-of-interest in C reorganization situations is met by the acquisition of substantially all of the properties of the acquired corporation.

[19] Even though the continuity-of-interest doctrine was made stricter in the 1934 Act with respect to the B and C types of reorganization, it is not necessary that this be interpreted as the sole form of the doctrine to be applied in the case of a B or C reorganization. The court-imposed concept of continuity of interest might still be deemed applicable in appropriate circumstances. In other words, making the doctrine stricter by statutory provision did not necessarily eliminate the possibility of a court still imposing, as is done in other areas of reorganizations, the basic concept of continuity of interest where appropriate. The mechanical test for continuity of interest did not necessarily supplant the court-imposed doctrine. This is even hinted at in the Regulations with respect to a C type of reorganization in which there is an assumption of liabilities. Regs. Section 1.368-2(d)(1) states that Section 368(a)(1)(C) ". . . does not prevent consideration of the effect of an assumption of liabilities on the general character of the transaction" and that the assumption may "so alter the character of the transaction as to place the transaction outside the purposes and assumptions of the reorganization provisions." Bittker, *Federal Income Taxation of Corporations and Shareholders* (1959) at p. 368 (a not-altogether unfitting page on which to deal with problems of reorganization definitions) points out: "This warning may mean that if the net worth of the transferred properties is insignificant, so that the consideration paid is primarily the assumption of indebtedness with only a trivial amount of voting stock to sweeten the bargain, the transaction will fail to qualify as a reorganization from want of a continuity of interest. . . ." See de Kosmian, "Tax Free Acquisitions of Assets on Stock," 15 *N.Y.U. Tax Institute*, 677, 679 at footnote 6, where it is implied that, if more boot than is permitted under Section 368(a)(2)(B) is given, the reorganization is not necessarily disqualified, but a continuity-of-interest doctrine is brought into play.

[20] The boot rules would, of course, apply in the case of A reorganizations (statutory mergers and consolidations) to cash or property other than stock (not necessarily voting or even common stock) given as part of the consideration in the exchange if the judicially imposed continuity-of-interest test were met, that is, enough stock were given to provide the requisite continuity of interest.

[21] Since only one share of stock would be sufficient under the Tax Court *Turnbow* and court of appeals *Howard* decisions to qualify a transaction as a reorganization, it is, of course, possible that the boot received would equal or exceed the gain.

[22] In neither *Howard* nor *Turnbow* was it considered whether boot received in a B reorganization should be treated as a dividend under Section 112(c)(2) (Section 356(a)(2) of the 1954 Code). In *Howard* the issue did not arise because the particular taxpayer involved received only stock for his stock; thus, he received no boot. In *Turnbow*, where cash boot was received, the issue simply was not raised in the Tax Court. It would seem apparent, however, that, if boot is permitted in the B reorganization, then dividend treatment of the boot under Section 112(c)(2) and Section 356(a)(2) is possible. See Kanter, *op. cit.*, *supra*, note 1; Donnelly, *op. cit.*, *supra*, note 1.

single share of stock constitutes part of the consideration, there is a reorganization and gain is subject to tax only under the boot provision and not the general taxing rule of Section 112(a). Now the choice may be up to the Supreme Court between giving primacy to the general operative taxing provision of Section 112(a), providing for full recognition of gain, or to the limited taxing provision of Section 112(c)(1), an exception to the general rule providing for recognition of gain only to the extent of boot.

Both the Ninth and Seventh Circuits made their respective choices based to a large degree on interpretations of legislative history and prior precedents. The Supreme Court, however, has often divided on the question of when, in statutory construction, resort should properly be had to legislative history. And the Court, of course, has the ultimate judicial power and responsibility for distinguishing or reversing prior case precedents, including its own. It would seem appropriate, therefore, to analyze the statutory pattern of Section 112 apart from its legislative history and from prior legal precedent to determine whether any conceivable interpretation would provide internal consistency and still give full meaning to each of its subsections and all of its words, recognizing, nevertheless, that precedent and history may be given their full measure in any ultimate decision.

Alternate interpretation

In the *Howard* case, it had to be decided whether "solely" in the B reorganization definition requires that *whatever* stock is acquired in a single transaction otherwise meeting the requirements of the definition be acquired for stock or whether only a *minimum* of 80% of the stock of the company being acquired needs to be acquired for stock, permitting anything over and above 80% to be acquired for cash or other property, in each instance requiring that *at least* 80% of the stock of the acquired company has been obtained. On the authority of numerous cases, in particular the Supreme Court case of *Southwest Consolidated Corp.* (315 U.S. 194, 1942), holding that the word *solely* left no leeway and permitted nothing other than stock to be given as consideration in a "C" reorganization, the Tax Court held that the requirement was not merely that only 80% had to be acquired for stock but was instead that all of the stock being acquired had to be acquired for stock and nothing else.[23] Had the matter been one of first impression and had the Tax Court been free to make its own determination (without regard to precedent and legislative history), it might have reached the opposite conclusion.[24] Perhaps if it had, some meaning could have been given to both the operative taxing provision of Section 112(a) and the limited taxing provision of Section 112(c)(1) as applied to a B reorganization.

If the rule were that only (a minimum of) 80% of the stock of the acquired corporation had to be acquired for stock, then it would be possible for boot to be given over and above the 80%. If less than the 80% were acquired for stock, Section 112(a) would be applicable, taxing the entire transaction on a capital gain basis, since it would not qualify as a reorganization under Section 112(g)(1)(B) and, therefore, would not be tax-free under Section 112(b)(3). If, however, 80% of the stock of the company being acquired were acquired for stock and there was additional consideration paid, the additional consideration would be boot and would be taxed under Section 112(c)(1). There would be a reorganization under the definition of Section 112(g)(1)(B) which would fall within Section 112(c)(1), because, except for the presence of the additional consideration, it would have qualified under Section 112(b)(3) for tax-free treatment.

Would this possible interpretation have been consistent with the fact that the solely-for-stock concept appears in both the definition provision of Section 112(g)(1)(B) and the taxing (or perhaps more accurately the no-taxing) provision of Section 112(b)(3)? The Tax Court in *Turnbow*, and in effect the court of appeals in *Howard*, ruled that Section 112(c) modified both Section 112(g)(1)(B) and Section 112(b)(3). The Tax Court in *Howard*, again on the basis of the existing authorities, held that Section 112(c) modified neither Section 112(g)(1)(B) nor Section 112(b)(3). To support a harmonizing interpretation, it would be necessary to emphasize that the solely-for-stock concept in the Section 112(g)(1)(B) reorganization definition is unmodified by any other subsection, to the extent it requires that only a minimum of 80% of the stock of the acquired company be acquired for stock, thus treating the definition as something to be met and complied with independently of any of the operative taxing prrovisions—Section 112(a), Section 112(b)(3), and Section 112(c)—and before the provisions of Section 112(b)(3) or Section 112(c) could come into play. As among the operative taxing provisions, however, it would have to be emphasized that the solely-for-stock concept under Section 112(b)(3) *is* modified by the *but-for* concept of Section 112(c), where consideration other than qualified stock is given in the exchange by the acquiring corporation solely for its voting stock is permitted tax-free even though the acquiring corporation already owns some of the stock of the other corporation. Such an acquisition is permitted tax-free in a single transaction or in a series of transactions taking place over a relatively short period of time such as twelve months."

[23] *Air Reduction Co.* (CA-2, 1942, 130 F.2d 145); *Pressed Steel Car Co.* (CA-3, 1945, 152 F.2d 280); *Central Kansas Tea Co.* (CA-10, 1944, 141 F.2d 213); *Elizabeth Bruce* (30 BTA 80, 1934, *rev'd* on different grounds, CADC, 1935, 76 F.2d 442); *Robert A. Pulfer* (43 BTA 677, 1941).

For a full discussion of these cases from a point of view different from that taken by the Tax Court or by either the Seventh or Ninth Circuits, see Rhoener on *Federal Taxation*, Vol. 5, No. 3 (November 6, 1959); Merritt, "Tax Free Corporate Acquisitions—The Law and the Proposed Regulations," 53 *Mich. L. Rev.* 911 (1955).

[24] The Tax Court itself recognized this possibility when it said: "We recognize that there is force to petitioners' argument that the practical objectives of the statute might well be satisfied if we were to adopt the construction urged. We think, however, that the authorities have clearly established the applicable rule of law to be that the consideration for whatever stock is acquired by the transferee corporation in a transaction such as that before us must be solely the transferee's voting stock, and nothing else."

[25] Theoretical consistency can only be obtained if Section 112(e) is also fitted into the picture. It would seem to fit, since, if the definition is met, the loss would not be allowed, whereas if the definition were not met, the loss would be allowed.

[26] "Properties" may be narrower than "assets," thus possibly permitting the retention of nonoperating assets to meet liabilities. See *Rev. Rul.* 57-518, 1957-2 CB 253. Transfer of 70% of a company's assets has been held to be sufficient, *Rev. Rul.* 57-518; but 68% has been held not to be sufficient, *Artic Ice Machine Co.* (23 BTA 1223, 1931). There is, however, no fixed rule as to percentage.

[27] This would no longer necessarily be the case under the 1954 Code, which permits the so-called "creeping" reorganization, that is, an acquisition in other than a single exchange involving only stock. This concept is expressed in the Regulations, Section 1.368-2(1) in the following manner: "the acquisition of stock of another corporation

[28] Revised report on Corporate Distributions and Adjustments to Accompany Subchapter C Advisory Group Amendments, submitted to the Committee on Ways and Means, December 11, 1958.

[29] For a critique of the effectiveness of this language to make the desired change, see Kanter, *op. cit., supra*, note 1.

[30] The stock to be given in a B or C reorganization would no longer need to be voting stock. The Subchapter C Advisory Group takes the position "that it should be immaterial whether the stock . . . received is voting or nonvoting, since the test should be that of an economic continuity of interest, rather than a right to vote."

over and above the required minimum stock consideration.[25]

Application of these possible interpretations, however – even if sound statutory analysis wholly apart from precedent and legislative history—is in practice not quite as easy in the case of a C reorganization, particularly since the Supreme Court case on which the conclusion of the Tax Court in *Howard* and the court of appeals in *Turnbow* are bottomed involved a C reorganization. The C reorganization definition provides that solely stock be given for substantially all of the properties of a corporation and not merely for 80% of the value of the corporation. It is, therefore, necessary to determine what is *substantially all the properties.*[26] Boot would be allowable over and above the stock deemed sufficient to acquire substantially all the properties of the corporation. This would presumably leave little room for boot, though perhaps some, thus permitting the several sections to be consistent at least in theory.

If the foregoing possible approach to the provisions of Section 112 were accepted, the final result in *Howard* and *Turnbow* would remain unchanged, but the court of appeals rationale in *Howard* would be disapproved. If, on the other hand, the word *solely* truly leaves no leeway (as the Ninth Circuit believes the legislative history indicates) and the *Southwest Consolidated* rule (followed by the Tax Court in *Howard* and the court of appeals in *Turnbow*) is not restricted to meaning simply that not *substantially all of the properties* of the corporation were there acquired for qualified stock, and the proper interpretation of the B reorganization definition is that all of the stock of the acquired company being obtained in a single transaction (provided this was not less than 80% of the company's stock[27]) and not merely a minimum 80% of the stock of the acquired company must be acquired for qualified stock and nothing else, then the result in *Howard* would be different, and the court of appeals reasoning would be disapproved; *Turnbow* would remain unchanged.

Although the future may include a Supreme Court decision with respect to these issues, broad legislative changes are also in the offing. The Subchapter C Advisory Group[28] proposals would reverse the principle of the court of appeals decision in the *Howard* case but leave the result in that particular case unchanged and would reach the same conclusion that is now reached by the court of appeals in the *Turnbow* case.

The Advisory Group would reverse the *Howard* case rule by amending Section 356(a) "to make clear that it operates only in a transaction which, independent of its provisions, qualifies as a reorganization under 368 . . .," specifically by changing the introductory words of Section 356(a)(1) to read: "If Section 354 would apply to an exchange made pursuant to a plan of reorganization . . . but for the fact. . . ."[29]

The proposed change in the rule of the *Howard* case would not change the result in that case because of other changes in the reorganization definitions proposed by the Advisory Group. The Advisory Group would view the B reorganization from two levels, so that with respect to each individual shareholder of the acquired company there would be a B reorganization (1) if at least two-thirds of the consideration he received for his stock were qualified stock of the acquiring corporation[30]—the balance of the consideration might be in cash or other property without destroying the B reorganization as to the particular shareholder—and (2) if the acquiring corporation has control of the acquired corporation immediately after the exchange or within six months thereafter. In *Howard*, since the particular taxpayer received only stock for his stock and since the requisite control under the proposed reorganization definition would have been obtained by the acquiring company, there would be no change in the result in the case.

Even though the allowable consideration in a B reorganization under the Advisory Group's proposals may consist of cash or other property (boot), the issue involved in the *Turnbow* and *Howard* cases would not be eliminated, in the same way the issue has not been eliminated in the 1954 Code in the revised definition of the C reorganization, which permits some boot, since the amount of permissible boot in both instances is strictly limited. In *Turnbow*, for example, the consideration taxpayer received for his shares was more than two-thirds in cash rather than stock; even under the revised reorganization definition there would be no B reorganization.

The boot rules applicable where there is a qualified reorganization under the Advisory Group's proposals are also to be substantially revised. The taxation of the boot would no longer be only to the extent of gain realized on the exchange. Instead, boot would be taxed *in toto* apart from any gain in the same way as it would have been taxed had the boot been a corporate distribution apart from a reorganization. Thus, the tax character of the boot would be determined as an ordinary dividend, a stock redemption, or a distribution in complete or partial liquidation, depending on how, in the circumstances, the distribution would have been treated if made by the acquired company without there having been a reorganization.

Clearly, the *Howard* and *Turnbow* cases would present to the Supreme Court, after many years, a unique opportunity to speak once again on some of the basic doctrines in the reorganization area. The Court could give important guidance and instruction not only on the proper analysis of the structure of the reorganization sections but also on the breadth of application of the continuity-of-interest rule. And happily, such guidance and instruction would not be limited solely to these 1939 Code cases but would be pertinent and of significant value to the proper interpretation of the 1954 Code and would help to delineate the proper area for and scope of revisions in Subchapter C. ☆

Proposed 269 Regulations list transactions indicating tax evasion

IN ITS LONG-AWAITED proposed Regulations on Section 269 the Treasury lists a number of examples of transactions that it describes as "transactions which ordinarily are indicative" that the principal purpose of the acquisition was evasion or avoidance of tax. At hearings held last month on these proposed Regulations practitioners argued that the IRS was in effect creating a presumption that had no basis in the statute or the cases.

Section 269, it will be recalled, provides that, if anyone acquires control of a corporation or acquires the property of a corporation at the transferor's basis

and if the principal purpose for the acquisition is evasion or avoidance of income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the deduction, credit, or allowance is disallowed. Transactions that must be carefully conceived and executed to avoid Section 269 troubles include those involving multiple corporations and loss carryovers. In them, proof of principal purpose has been difficult when there are some business motives.

Proposed Regulation Section 1.269-3 details instances in which Section 269 disallows a deduction, credit, or other allowance. It contains the following introductory language: "The transactions set forth in the following subparagraphs are among the transactions which ordinarily are indicative that the principal purpose for which such acquisition of control or property was made is avoidance or evasion of Federal income tax."

This statement, it was argued, in effect creates a presumption that the described types of transactions have as their principal purpose tax avoidance or evasion. It was foreseen that, if preserved in the final Regulations, it will force litigation in almost every Section 269 case except those involving highly unusual facts. It was forcefully urged that there was nothing in the case law, the legislative history or 269, or the prior Regulations to justify this stand.

As a matter of equity, practitioners said, if the Regulations are adopted as proposed, they should be applicable only prospectively.

The proposed Regulations contain two examples of tax-free transfers of profitable assets to use up losses which the Regulations would regard as coming under the ban of Section 269. In one example a loss corporation was bought for the purpose of revitalizing it. Later the buyer transferred a profitable business to it (the old business was continued) to help use up the losses. (Prop. Regs. Section 1.269-6, Example 3). In the other example a parent transfers a profitable business to a subsidiary to help use up its losses (Prop. Regs. Section 1.269-3(c)(2)). In both cases the transfers involved a carryover of basis.

These rules were assailed as illogical (and not in accord with the intention of Congress) because the same result and unquestioned use of the loss carryover could have been achieved had the taxpayer used different forms. If the transfer of assets or business had been done by a sale, the loss carryover would not be jeopardized. Analysis of the statute and its history shows, it was urged, that Section 269 was intended to apply only when there was a connection between the transferred basis and the tax credit, allowance, or deduction.

A question which has long agitated commentators is the relationship between Section 269 and other sections of the Code, especially Sections 381 and 382, which specify the attributes carried over to successor corporations and which reduce loss carryovers when there is a change of ownership and of business. The proposed Regulations take the position that Section 269 may be applied even though a carryover is not disallowed under Section 382.

It was urged by several of the witnesses that the IRS position on the applicability of *Libson Shops* to the 1954 Code ought to be clarified in the Regulations. No direct mention is made of it, yet the idea that losses should be allowed only against the profits of the business that suffered them runs through (and seems to be the only justification for) several of the examples in which the Regulations say that Section 269 applies. ☆

New corporate decisions this month

Gain on sale of completed construction contracts not taxed to corporation liquidating under Section 337. A corporation had three contracts under which it had performed all of the required work but upon which settlement had not been made. In the course of a 12-month liquidation under 1954 Code Section 337, the corporation sold the contracts to a purchaser for value and sought non-recognition of the gain on the sale. The Commissioner argued that the contracts were not property within the meaning of Section 337, and therefore, gain should be recognized. The Tax Court rules that the contracts were property for purposes of Section 337 and permits non-recognition of the gain. *Central Building and Loan Association* (34 TC 447) can be distinguished, the court says. That case involved the assignment of earned but uncollected interest owing to a liquidating corporation. That transaction was not a sale but was a collection of interest. *Kuckenberg*, 35 TC No. 55.

After liquidation, shareholders set longer lives for assets; corporation's open years recomputed. Taxpayer distributed depreciable assets to its shareholders in liquidation. The shareholders began to depreciate them over longer useful lives than the corporation had used. Using these new lives, the Commissioner recomputed taxpayer's depreciation deduction for the last two years of its life. The Tax Court upholds the Commissioner. The fact that taxpayer had in earlier years been allowed higher depreciation based on shorter lives is immaterial. *Kuckenberg*, 35 TC No. 55.

Unrealized profit on incomplete construction contract taxed to liquidating corporation. Taxpayer, a construction corporation, used the cash basis. It decided to liquidate and assigned an incompleted contract to its shareholders. Up to the time of liquidation, the expenses of the contract had exceeded the amounts received by the taxpayer. Asserting that the taxpayer was using an accounting method that did not clearly reflect income, the Commissioner allocated to taxpayer the same proportion of the ultimate total receipts under the contract as its costs were of the total costs incurred. The court approves. *Kuckenberg*, 35 TC No. 55.

Earnings and profits are reduced by recovered cost of contract having no fair market value. The corporation being liquidated was the owner, in perpetuity, of a contract entitling it to receive 300 primary horsepower of electricity annually from a power company. The company had acquired the contract in 1929 at a cost of $75,000. The corporation was liquidated pursuant to Section 333 of the Code. The question before this court is the amount of earnings and profits of the corporation at the date of its liquidation. Applying *Burnet* v. *Logan* (283 U.S. 404), this court finds that the contract had no ascertainable fair market value, and the indefinite amounts to be received thereunder were contingent upon facts and circumstances beyond the control of the taxpayer. Thus, since the corporation was entitled to recover its cost in the contract before recognizing taxable income on amounts received from the

sales of power, this cost should have been deducted from the company's earnings and profits in determining the amount of earnings and profits distributed to the shareholders in a Section 333 liquidation. *Curry*, DC S. C., 12/14/60.

Loss carryovers, interest deductions, and capital gains on bond redemption disallowed under 269. Taxpayer's controlled corporation published newspapers for armed forces personnel. For $1 he purchased all the stock of a near-bankrupt competitor and its worthless note of more than $200,000, upon which interest had never been paid. The newspaper of the latter company was discontinued, its name was changed, and it became a sales company for taxpayer's publishing corporation. The promissory note held by him was exchanged for 10-year 3% debentures, part of which he gave to others. The sales company sold all its copyrights, trade names, circulation rights, etc., to the publishing company, and the latter agreed to pay the former 40% of the subscriptions it generated. The solvent corporation also provided supplies, equipment, and initial financing as advances against such commissions. The sales company profited and paid interest on the debentures. It never paid a formal dividend. It redeemed a relatively small amount of its debentures held by taxpayer. Under the authority of Section 129 of the 1939 Code the Commissioner disallowed the sales corporation's net operating loss carryover from its publishing days and also disallowed the interest deduction claimed for the debentures. On the same theory taxpayer's asserted capital gain on the bond redemption was changed to ordinary income. The Tax Court agreed. In finding the prohibited purpose, it considered the "immediate, proximate, and reasonably to be anticipated consequences" of the taxpayer's actions and found them to be the securing of definite and valuable tax advantages. It thought implausible taxpayer's contention of bona fide business purpose in light of the facts surrounding the acquisition and the pattern and sequence of various events. Mention was also made of his success in his own ventures and that he had tax counsel. Having found the proscribed purpose, the court relied on *Snyder* (34 TC 400) and *Urban Redevelopment Corporation* (34 TC No. 87) as authority that Section 269 can deny a deduction, even though the taxpayer claiming it did not itself come within the section. *Army Times Sales Co.*, 35 TC No. 75.

Sale to controlled corporation comes within ordinary-income provision. Section 117(o) of the 1939 Code (now Section 1239) treats as ordinary income gain by individuals on selling depreciable assets to their controlled corporations. It applies to transfers occurring after May 31, 1951. Taxpayer here claims his sale of a patent to his corporation occurred before May 31, 1951. In January of that year he assigned an interest in his patent and application to himself, his wife, and his attorney as organizers of a corporation to be created. It was formed in November, and on December 1, 1951, the taxpayer and the corporation executed a new contract which purported to adopt the earlier agreement. The court holds that there could not have been a sale of the patent rights to the corporation prior to its incorporation on November 28, 1951. Further, it holds that the rights of the patents did not pass prior to December 1, 1951, when the corporation affirmed or adopted the January 31 agreement. Under Texas law, adoption or acceptance is regarded as the execution of a new contract and an original undertaking by the corporation. The theory of ratification with its resultant retroactive affirmation of promoter's contracts has been rejected by Texas courts. Section 117(o) applies, and the gain on the sale (the royalty) is ordinary income. *Twining*, DC Tex., 12/30/60.

Oil and gas corporation held not collapsible. After the principal partner in a family partnership had an operation for cancer, he set about to put his affairs in order. Among other things, the oil and gas producing business operated by the family partnership was transferred to a corporation. About one and one-half years later, after the corporation had acquired new leases and made new discoveries, the corporation sold all its oil and gas leases at a substantial profit. The sale was made pursuant to a plan of complete liquidation within 12 months under Section 337. The corporation, therefore, reported no gain or loss on the sale. The District Director determined that the corporation was a "collapsible" corporation and, therefore, was not entitled to benefit from the non-recognition provisions of Section 337. This court finds that there was no intent to liquidate the corporation before a substantial part of the taxable income from the leases had been realized and that there was no intent to convert ordinary income into capital gain through device of a corporation. There had been no need to utilize the corporate form to realize a capital gain. The primary view in incorporating had been to provide for stockholder's family; taxes were not thought of until later. *Honaker Drilling, Inc.*, DC Kan., 12/30/60.

Officer's reasonable compensation established. [*Acquiescence*] The Tax Court determined the reasonable compensation of taxpayer's president and principal stockholder and disallowed the excess deducted. In so doing, the court recognized that the officer's meager salary in earlier years was attributable to taxpayer's poor financial position rather than to the officer's lack of qualification. *Coe Laboratories, Inc.*, 34 TC 549, *acq.*, IRB 1961-4.

Change of business loses loss carryover; Libson Shops followed. [***Old law***] A loss corporation, in manufacturing, merged on December 31, 1953, with taxpayer, a profitable real estate corporation. The manufacturing operations were continued for a few months in a curtailed fashion and subsequently discontinued. Taxpayer deducted the pre-merger loss carryover against its income, both pre-merger and post-marger. On the authority of *Libson Shops*, the Tax Court denies the deduction. The income against which the offset was claimed was not produced by substantially the same business that incurred the losses. The case arose in a 1939-Code year. Sections 381 and 382 of the 1954 Code, providing specific rules for loss carryovers, are not applicable. *Irving-Kolmar Corp.*, 35 TC No. 77.

IRS lists nontaxable exchanges of Government bonds. Section 1037 of the Code, added in September 1959, gives the Secretary of the Treasury the authority to designate as tax-free certain exchanges of U. S. Government obligations at call or maturity for new obligations. The IRS here summarizes the revenue rulings issued during 1959 and 1960 listing the various exchange offerings of the Treasury that will be tax-free exchanges, not taxable sales and purchases. TIR 292.

TAXATION OF

Partnerships

EDITED BY JAMES O. HEWITT LL.B., CPA

New Regulations provide workable rules for real estate limited partnerships

by SIDNEY I. ROBERTS & HERBERT H. ALPERT

Real estate syndicators, disturbed over some of the provisions in the proposed Kintner Regulations, find that the final Regulations have met most of their objections. Mr. Roberts and Mr. Alpert analyze these Regulations and point out the areas in which particular caution will be needed to avoid qualification as an association taxable as a corporation.

DURING THE PAST FEW MONTHS, there have been two major developments in the tax law affecting widely held ownership of real estate. The first of these developments, the enactment of the real estate investment trust provisions of the Code,[1] has received more attention and may eventually have a substantial impact on real estate syndications. However, the second of these developments, the promulgation of the final "association" Regulations, is, by far, of more significance.

The last 20 years have seen a tremendous growth in widely held ownership of real estate. This growth has been made possible by the ingenious adaptation of the limited partnership form as a vehicle for such ownership. Under the 1939 Code Regulations dealing with associations,[2] a limited partnership could generally be organized in such a manner that it would afford some advantages of incorporation, but still retain its classification as a partnership[3] and thus avoid the corporate tax.

In 1959, it became generally known that the Treasury was considering a substantial revision of its Regulations distinguishing between partnerships and associations taxable as corporations. Naturally, the real estate syndication industry became very apprehensive, since its very existence was at stake. However, the publication of the final Regulations put its fears to rest. Indeed, the Regulations now permit a greater degree of certainty and flexibility than was previously available.

The purpose of this article is to examine these Regulations with particular reference to limited partnerships[4] formed under a statute corresponding to the Uniform Limited Partnership Act.[5]

The Morrissey rule

As a starting point, the Regulations adopt the basic principle of the *Morrissey* case:[6] "An organization will be treated as an association if the corporate characteristics are such that the organization more nearly resembles a corporation than a partnership or trust."[7]

The Regulations first describe two characteristics, both of which are essential to classification as an association: (1) associates and (2) an objective to carry on business and divide the gains therefrom.[8] The first of these characteristics, by hypothesis, exists in every limited partnership. With respect to the second characteristic, where the sole purpose of the partnership is to hold property subject to a net lease to the operator, it is certainly arguable that the partnership does not have an objective to carry on business.[9] However, for purposes of the discussion that follows, this second characteristic is assumed to be present.

The four remaining major corporate characteristics specifically considered by the Regulations are:

1. Continuity of life.
2. Centralization of management.
3. Limited liability.
4. Free transferability of interests.[10]

A limited partnership, like an ordinary partnership, is dissolved on the retirement, death, or insanity of a general partner (with certain exceptions discussed below).[11] However, a dissolution does not necessarily require the winding up of the partnership, *i.e.*, the sale of its assets and the distribution of the proceeds; the business may be continued by the remaining members. It is the provisions for such a continuation in partnership agreements that raise the question of whether the limited partnership has the continuity of life that is characteristic of a corporation.

Continuation provisions may take a variety of forms. The simplest type is one which allows the business to be continued only with the consent of all partners, both general and limited. Under the 1939 Code Regulations, it was clear that such a provision would not establish corporate continuity of life.[12] However, obtaining the consent of all members is not always feasible, particularly in a real estate syndication involving several hundred members. Accordingly, one common practice in real estate limited partnerships has been to allow the remaining general partners alone to have the right to continue.

Under one form of such a continuation provision, the remaining general

[1] For a first look at the real estate investment trust provisions, see Roberts, Feder, and Alpert, "Congress approves real estate investment trusts," 13 JOURNAL OF TAXATION 194 (1960). See also Roberts and Schapiro, "Real Estate Investment Trusts," *19th NYU Institute on Federal Taxation* (1961).

[2] Reg. 118, Section 39.3797-5.

[3] Section 7701(a)(2) defines the term partnership as including all types of unincorporated business or financial organizations which are not, within the meaning of the Code, trusts, estates, or corporations. Section 7701(a)(3) defines the term corporation to include associations. The term associations is left undefined.

[4] For a more general discussion of the Regulations, see Wolfman and Price, "Qualifying under final Kintner rules will be difficult in most states," 14 JOURNAL OF TAXATION 105 (1961).

[5] *E.g.*, Article 8 of the New York Partnership Law. The Uniform Limited Partnership Act, the Uniform Partnership Act, and the New York Partnership Law will be referred to herein as the "ULPA," the "UPA," and the "NYPL."

[6] *Morrissey* (296 U.S. 344, 1935).

[7] Reg. Section 301.7701-2(a)(1). This principle is expressly made applicable to limited partnerships in Reg. Section 301.7701-3(b)(1).

[8] Reg. Section 301.7701-2(a)(2).

[9] See *Cleveland Trust Co.* (115 F.2d 481, CA-6, 1940); *cf. McCoach* v. *Minehill & S. H. R. Co.* (228 U.S. 295, 1913); but see *Main-Hammond Land Trust* (200 F.2d 308, CA-6, 1952).

[10] Reg. Section 301.7701-2(a)(1) and (2).

[11] See text at note 23, *infra*.

[12] *Rev. Rul.* 54-484, 1954-2 CB 242.

[13] See note 23, *infra*.

[14] 46 BTA 176, 1942, *acq.* 1942-1 CB 8.

[15] *Ibid.* at 185, 186.

[16] The deceased or retired general partner is given

partners are given the right to continue the business, which, if exercised, would seem to prevent the limited partners from withdrawing their contributions.[13] This type of provision was considered in the *Glensder Textile Co.*[14] case decision, where the Tax Court stated the following:

"A contingent continuity of existence had been provided for by the reservation in the certificate of the power of the surviving general partners to continue the business on the death, retirement, or incapacity of a general partner. We do not think this analogous to the chartered life of a corporation which continues regardless of the death or resignation of its directors or stockholders. A limited partnership is dissolved by death, as an ordinary partnership, unless the right to continue is retained, but continuity is not assured by this power, for it is one vested in the several general partners, apparently, and not in the partnership as an entity. Continuance will be certain only if the remaining general partners agree to it, as would be the case, in substance, in a general partnership. In an ordinary partnership, on the death of a partner a new partnership as formed; here the old partnership continues but receives new life, in effect, from the decision of the members. Moreover, on a general partner's death his interest must be paid over to his personal representative, and the capital of the partnership is to that extent liquidated."[15]

In the last sentence quoted above, the Tax Court noted that, upon a continuation of the business, the interest of the deceased or retiring general partner was to be liquidated. Accordingly, most limited partnership agreements have provided that the retiring general partner, or the estate of a deceased general partner, has the option of receiving the value of his interest or continuing on as a limited partner.

Many syndicators' attorneys, however, were reluctant to rely solely on the *Glensder* case. Accordingly, their agreements have provided that the death or withdrawal of a general partner dissolves and terminates the partnership, but the remaining general partners have the right, but not the obligation, to form a "new" limited partnership employing the assets and name of the old partnership. The remaining general partners and the limited partners of the old partnership would become the general and limited partners, respectively, of the new partnership.[16] Any limited partner, however, may refuse to participate,[17] and receive a return of his contribution, usually determined on the basis of appraised values.[18]

The effect of this latter type of provision is that neither the general nor the limited partners are "locked in." Under such circumstances, the partnership would appear to have no more continuity of life than where the consent of all members is required for a continuation of the business. For example, if the consent of all members were required and one or more refused to consent, the remaining members could buy the assets of the organization, pay the dissenters their share of the proceeds, and continue the business.[19]

Proposed dissolution rule

The proposed Regulations attempted to eliminate the uncertainty that existed in this area under prior law. The existence of continuity of life was made to depend on whether the partnership would be "dissolved" on the "death, insanity, bankruptcy, retirement, resignation or expulsion of any member."[20] Dissolution was defined as "an alteration of the identity of an organization by reason of a change in the relationship between its members as determined under local law." [21] The function of local law under the proposed Regulations was to determine the rights and duties of the members upon the death or withdrawal of a partner. Accordingly, it would appear to be immaterial whether local law also characterized these rights and duties as a dissolution. For the most part, this distinction is academic, since the proposed Regulations defined dissolution in substantially the same terms as does local law.[22] Unfortunately, this identity of tax and local law definition of dissolution might not be true in the case of a limited partnership.

Section 20 of the ULPA (NYPL Section 109) provides as follows: "The retirement, death or insanity of a general partner dissolves the partnership, *unless* the business is continued by the remaining general partners (a) Under a right so to do stated in the certificate, or, (b) With the consent of all members." (Emphasis added.)

Although no authority has been found on the question, the above provision seems to imply that there is no dissolution under local law if the business is continued under the conditions stated in subsections (a) or (b) thereof.[23] In other words, the death or withdrawal of a member would not necessarily cause a dissolution as that term is used under local law. In commenting on the proposed Regulations before the Internal Revenue Service,

[*Sidney I. Roberts, who regularly appears in these pages as editor of the foreign department, practices law in New York City as a member of the firm of Roberts & Holland. Herbert H. Alpert, a member of the New York bar, is associated with that firm.*]

---

the right to convert his interest to that of a limited partner. If this right is not exercised, the remaining general partners are usually given the power to admit a new general partner to take the place of the deceased or retired partner.

[17] It is generally provided that any limited partner who does not dissent within a specified time (often 15 days) after notice of the general partners' intention to form a new partnership is deemed to have consented, and an "irrevocable" power of attorney is granted to the general partners to execute and file the new partnership certificate.

[18] If the withdrawing limited partner were entitled to receive significantly less than he would have received if the partnership business had been wound up, it might be argued that the limited partner is, in effect, economically compelled to continue in the business.

[19] For an example of this type of provision, see the partnership agreement of Motors Building Realty Company, a limited partnership formed to hold for investment the leasehold interest in the property known as the General Motors Building. Both the partnership agreement and a favorable ruling thereon may be found in a Registration Statement on file with the Securities and Exchange Commission.

[20] Prop. Reg. Section 301.7701-2(b)(1).

[21] Prop. Reg. Section 301.7701-2(b)(2).

[22] UPA Section 29; NYPL Section 60.

[23] This construction may be justified by the relationship of ULPA Section 20(a) to ULPA Section 16 (NYPL Section 105). Section 16 provides that a limited partner may demand a return of his contribution on the date specified in the certificate or on the "dissolution" of the partnership. Thus, if the death or withdrawal of a general partner prior to the agreed term were called a "dissolution" under local law, the limited partners might be able to effectively terminate the partnership business by demanding a return of their contributions. This would be inconsistent with the basic concept of a limited partnership. The reason for the adoption of the original limited partnership statutes was to allow businessmen to secure capital from others in exchange for an interest in the profits without subjecting the investors to personal liability. Prior to the adoption of these statutes, it had been held that a creditor with an interest in profits would be personally liable. See 8 U.L.A. 2-5. Since limited partners are basically subordinate creditors, the limited partners are merely given a veto power with respect to certain specified situations which might substantially affect the nature of their original undertaking. See ULPA Section 9; NYPL Section 98. Similarly, it would follow that the limited partners might be denied the right to withdraw until the end of the agreed term so long as the general partners desire to continue the business.

the Association of Real Estate Syndicators, Inc., suggested that the effect of ULPA Section 20 on continuity of life be clarified. It was argued that local law terminology was immaterial; that the ULPA and UPA indicate that, on the death of a general partner of a limited partnership, the general partners have the same rights and powers as do the members of an ordinary partnership, *i.e.*, the mutual agency among them terminates and the withdrawing general partner or estate of the deceased general partner would seem to have the same rights as is provided by UPA Sections 38 and 42 (NYPL Sections 69 and 73) in the case of a dissolution of an ordinary partnership; and that, therefore, the death or withdrawal of a general partner would cause a dissolution *within the meaning of the Regulations*, even though it would not be so labeled under local law.[24]

A second argument made by the Association was that ULPA Section 20 merely provides a *contingent* continuity dependent upon the volition of the general partners. Under the *Glensder* case, *supra*, this clearly did not establish corporate continuity of life.

The final Regulations have eliminated these questions. In addition to retaining the provisions of the proposed Regulations discussed above,[25] the final Regulations have added the following:[26]

"If the retirement, death, or insanity[27] of a general partner of a limited partnership causes a dissolution of the partnership, unless the remaining general partners agree to continue the partnership or unless all remaining members agree to continue the partnership, continuity of life does not exist [citing *Glensder*]."

In fact, the Regulations now go so far as to provide that "a limited partnership subject to a statute corresponding to the [ULPA] . . . lack[s] continuity of life."[28]

In drafting a continuation provision for a new limited partnership, several factors should be considered. First, it would be desirable to follow the statutory form, *i.e.*, allowing the remaining general partners to continue the business if they so choose. There appears to be no tax reason for perpetuating the type of provision permitting the formation of a "new partnership" to continue the business, which would seem to allow dissenting limited partners to withdraw.[29] From the business viewpoint, it may well be preferable to "lock in" the limited partners until the end of the partnership term.

Second, in order to keep the limited partners "locked in" until the general partners determine to wind up the business, the stated term of the partnership should be sufficiently long.[30] The Regulations use 40 years as an example,[31] but there appears to be no reason why it could not be longer.

Third, it would be desirable to have several general partners in order to increase the probability that at least one general partner will remain to continue the business until the end of the agreed term or the sale of the assets.

Suppose, however, that after several years of operation, a limited partnership is left with only one general partner. In such a case, in order to avoid an untimely termination of the partnership in the event of his death or withdrawal, it might be desirable to admit a new general partner. Under ULPA Section 9(1)(e) (NYPL Section 98(1)(e)), the general partners do not have this authority except with the consent of *all* the limited partners "to the specific act." Possibly, the partnership agreement might provide that if a stated percentage of the limited partners consent to the admission of a new general partner, all the limited partners shall be deemed to have consented. Assuming such a provision to be valid,[32] it would not appear that this provision would establish continuity of life under the Regulations. First, the Regulations state unequivocably that a limited partnership formed under the ULPA cannot have continuity of life. Second, the partnership would nevertheless be dissolved on the death or withdrawal of a general partner unless the business is continued.[33]

Centralization of management

The proposed Regulations took the position that every limited partnership has centralized management because only the general partners had authority to bind the partnership by their acts.[34] Again, the Association of Real Estate Syndicators objected, principally on the ground that the centralized management of a limited partnership did not resemble that of a corporation because the general partners, unlike the directors of a corporation, did not act in a *representative capacity*. This was the test adopted in the Regulations under the 1939 Code,[35] apparently in reliance upon the following language from the *Morrissey* case:[36]

"Corporate organization furnishes the opportunity for a centralized management *through representatives* of the members of the corporation." (Emphasis added.)

As was stated in *Glensder Textile Co.*, *supra:*

"There was centralized control by the general partners, but this fact did not make them analogous to directors of a corporation. They were acting in their own interest as hitherto, which constituted five-twelfths of the partnership, and not merely in a representative capacity for a body of persons having a limited investment and a limited liability."[37]

The arguments of the Association prevailed to a considerable extent. The final Regulations state:

"[L]imited partnerships subject to a statute corresponding to the [ULPA], generally do not have centralized management, but centralized management ordinarily does exist in such a limited partnership if substantially all the interests in the partnership are owned by the limited partners."[38]

The final Regulations appear to take the position that unless the limited partners own "substantially all the interests," the general partners are not acting in a representative capacity.[39] The Regulations indicate that where the limited partners invested $5 million out of $5,300,000, or about 94%, substantially all the interests are owned by the limited partners.[40] On the other hand, where the general partners own five-

[24] Note that the Regulations defined the term "dissolution" "for purposes of this paragraph [relating to continuity of life]." This would indicate that the Regulations' concept of dissolution was separate from any local law concept.

[25] Reg. Section 301.7701-2(b)(1) and (2).

[26] Reg. Section 301.7701-2(b)(1).

[27] Presumably a limited partnership would also be "dissolved" on the bankruptcy or expulsion of a general partner (*cf.* UPA Section 31; NYPL Section 62). However, apparently for the purpose of eliminating any possible ambiguities, the Regulations have followed the language of the ULPA Section 20, thus avoiding reference to "bankruptcy" or "expulsion."

[28] Reg. Section 301.7701-2(b)(3).

[29] *Cf.* ULPA Section 16(2)(a); NYPL Section 105(2)(a).

[30] Many of the existing partnership agreements give the general partners the right to form a new partnership to continue the business after the expiration of the term of the old partnership. However, this would seem to raise unnecessary complications.

[31] Reg. Section 301.7701-3(b)(2), *Example (2)*.

[32] A similar provision has been commonly used in

twelfths of the interests, the *Glensder* case indicates that centralized management does not exist. Between these extremes little guidance is available.

The Regulations present some further questions. For example, is the amount of capital invested by the general and limited partners, respectively, the sole factor to be considered? Frequently, the general partners are entitled to an "override" in profits, refinancing proceeds and sale proceeds above a specified amount. It would seem that this should be taken into consideration, particularly in situations where it is likely that they will be substantial.[41] Another unresolved question is whether the interests of general partners should be aggregated with the interests they may also have as limited partners.

If substantially all the interests are not owned by the limited partners, a limited partnership will not be considered to have centralized management, regardless of how the management powers may be divided among the general partners. Thus, it is immaterial that under the partnership agreement only one of the general partners, rather than a majority, is authorized to manage the business. The Regulations consider it sufficient that every general partner has apparent authority to bind the partnership in transactions with third parties having no knowledge of the limitation.[42]

Limited liability

An organization is considered to have the corporate characteristic of limited liability if *none* of its members are personally liable for the debts of the organization.[43] Under the proposed Regulations the existence of personal liability depended upon two factors: whether a member was personally liable under local law and, if so, whether that member had substantial assets which could be reached by a creditor of the organization.[44] Presumably, the proposed Regulations were based on the following language from *Glensder Textile Co.*:

"If, for instance, the general partners were not men with substantial assets risked in the business, but were mere dummies without real means acting as the agents of the limited partners, whose investments made possible the business, there would be something approaching the corporate form of stockholders and directors."[45]

In its comments submitted to the Treasury, the Association of Real Estate Syndicators argued that the proposed Regulations went far beyond the *Glensder* case: The above-quoted language indicates that, if the general partners of a limited partnership are mere dummies, then the characteristics only of the limited partners determine whether the organization resembles a corporation. However, a dummy is therein described as a person who (1) is without real means and (2) is acting as the agent of the limited partners. Lacking either of these characteristics, a general partner cannot be regarded as a mere dummy. Thus, the court in *Glensder* continued as follows:

"But, as a practical matter, to suppose such a situation we must also suppose that the limited partners were, in reality, not merely silent partners without control of affairs but were empowered to direct the business actively through the general partners."[46]

The proposed Regulations, if read literally, drastically differed from the conception of the court in the *Glensder* case. Suppose, for example, two impecunious lawyers, recently admitted to the bar, form a law firm. It is clear that they would not have limited liability analogous to that of stockholders because, as indicated in *Glensder*, they would not be acting as agents of other silent partners. However, the language of the proposed Regulations suggested that the law firm would have the corporate characteristics of limited liability, presumably on the premise that the partners would not be personally liable for the debts of their partnership, a conclusion at odds with basic concepts.

The final Regulations significantly modify the test for determining the existence of limited liability. With respect to organizations other than limited partnerships, limited liability will not exist if any member is personally liable under local law; there is no substantial-assets test.[47] The rule with respect to limited partnerships is generally clear. However, perhaps in part because the changes in the final Regulations were engrafted on the proposed Regulations instead of being entirely rewritten, there is some ambiguity between the language of the proposed Regulations that was retained in the final Regulations and the language added by the final Regulations.

The final Regulations state that personal liability does not exist with respect to a general partner unless *either* (1) he has substantial assets (other than his partnership interest), *or* (2) he is not "merely a dummy acting as the agent of the limited partners."[48] However, the Regulations then state that, when the limited partners act as the principals of the general partners, the limited partners are personally liable.[49] Since the existence of personal liability on the part of any one member of the partnership is sufficient to negate the corporate characteristic of limited liability,[50] it would seem that a limited partnership could never have limited liability, regardless of whether any member has substantial assets. Accordingly, the reference to the substantial-assets test would have no significance, at least in the case of the common, garden-variety real estate syndicate.

The Regulations further state that where a corporation is a general partner,[51] personal liability will exist when the corporation has substantial assets.[52] Similarly, the Regulations state that a general partner who contributes services, but no capital, is personally liable if he has substantial assets.[53] No mention is made in these sentences of the situation where either such general partner does not have substantial assets but is not

connection with obtaining the consent of the limited partners to a sale of assets by the general partners.

[33] As to whether the existence of such a provision would be considered another factor "significant" in classifying the organization, see text at note 63, *infra*.

[34] Prop. Reg. Section 301.7701-2(c) (4).

[35] Reg. 118, Section 39.3797-5.

[36] 296 U.S. 344, 1935.

[37] 46 BTA at 185. See also *Junior Miss Co.* (14 TC 1, 1950, *acq.* 1950-1 CB 3).

[38] Reg. Section 301.7701-2(c) (4).

[39] But see note 42, *infra*.

[40] Reg. Section 301.7701-3(b) (2), *Example (1)*.

[41] For example, suppose the general partners are to receive 20% of the annual profits in excess of a 10% return on the cash investment of the partners, and that the partnership property is subject to a lease producing a 15% return. Note that the Regulations state that if the limited partners own substantially all the interests, centralized management "ordinarily" exists. Possibly the case just discussed may be one of the exceptions which are implied by the Regulations.

[42] Reg. Section 301.7701-2(c) (4).

[43] Reg. Section 301.7701-2(d) (1).

[44] Prop. Reg. Section 301.7701-2(d) (1) and (2).

[45] 46 BTA at 183.

[46] *Ibid.*

[47] Reg. Section 301.7701-2(d) (1).

[48] Reg. Section 301.7701-2(d) (2).

[49] Reg. Section 301.7701-2(d) (2).

[50] Reg. Section 301.7701-2(d) (1).

[51] In New York and perhaps in other states, it may be doubtful whether a corporation can be a general or limited partner.

[52] Reg. Section 301.7701-2(d) (2).

[53] Reg. Section 301.7701-2(d) (2).

acting as an agent for the limited partners. This omission of the dummy test, coupled with the fact that the substantial-assets test would appear to have no significance where the dummy test is applicable, might suggest that the dummy test is inapplicable to corporate general partners or general partners contributing services only. However, the concluding sentence of the applicable subparagraph Reg. Section 301.7701-2(d)(2)) would seem to preclude such a construction. It states:

"*In addition,* although the general partner has no substantial assets . . . personal liability exists with respect to such general partner when he is not merely a dummy acting as the agent of the limited partners."

This provision would seem to encompass all the general partners referred to in the preceding portions of the same subparagraph, including both corporations and those who contribute only services.[54]

Free transferability of interests

The Regulations provide[55] that an organization does not have free transferability of interests unless each of its members, or those members owning substantially all the interests, have the power, without the consent of other members and without causing a dissolution,[56] to substitute for themselves a person who is not a member. The power of substitution means the right to confer on a substitute all the attributes of the transferor member's interest. Thus, the mere power to assign an interest in profits and capital does not establish free transferability.[57]

If the limited partners do not own substantially all the interests,[58] the partnership will automatically lack free transferability, since a general partner can neither retire from the partnership without causing a dissolution nor admit a new general partner without the consent of all members. On the other hand, if the limited partners do own substantially all the interests, the existence of free transferability will depend upon whether a limited partner is empowered to give his assignee the right to become a substitute[59] limited partner.[60] Absent a provision to the contrary, a limited partner does not have this right.[61]

The Regulations merely refer to the power to substitute "a person" in the place of the transferor. Does this mean *all* persons or *some* person? For example, suppose a limited partner's interest is freely transferable, but only to members of his immediate family. While conceivably the Regulations could be read otherwise, the limited circle of permitted transferees could hardly be considered comparable to the attributes of transferability accorded to stock of a corporation.

Some partnership agreements provide that a limited partner must give the other members a right of first refusal in the case of a transfer of his interest. If the offer to the other members is rejected, the limited partner may transfer his interest to a non-partner, who then becomes a substituted limited partner. Under the Regulations, this would constitute a "modified" form of free transferability, which is given "less significance" than the unmodified form.[62] This distinction is a carryover from the proposed Regulations, but its effect is obscure in the context of certain changes made in the final Regulations, discussed in the succeeding section.

The Regulations state that, in addition to the four major corporate characteristics discussed above, "other factors may be found in some cases which may be significant in classifying an organization."[63] Unfortunately, however, what these other factors may be is left to speculation.

Prior to the issuance of the proposed Regulations, some concern was expressed that the Treasury was considering making the number of members a factor to be taken into account.[64] However, this view was not adopted in either the proposed or the final Regulations.[65] In fact, the Regulations give an example of a limited partnership having 903 members which is classified as a partnership.[66] In discussing the corporate characteristics of this partnership, no mention is made of the number of members, presumably because this factor is not significant.[67]

A factor sometimes mentioned by the courts in dealing with the association question is whether the organization contemplated that its interest would be freely transferred. In other words, the courts have taken notice of whether certificates have been issued to evidence an interest in the organization.[68] This raises the question of whether the use of such certificates would be a significant factor. A second conceivable factor might be whether the interest of a deceased or retired partner is liquidated when the business is continued. Third, it is conceivable that the right to admit additional limited partners might be significant.

Each of these three factors relates to one of the four major corporate characteristics expressly discussed in the Regulations and, accordingly, would seem to have no independent standing as another significant factor. For example, the use of certificates would re-

[54] That the discussion of substantial assets may be merely a carryover from the proposed Regulations is further indicated by *Examples (1)* and *(2)* of Reg. Section 301.7701-3(b)(2), where the substantial-assets test is applied, although the individual general partners contributed property and not services to the partnership.

[55] Reg. Section 301.7701-2(e)(1) and (2).

[56] Dissolution would appear to have the same meaning here as in Reg. Section 301.7701-2(b)(2), relating to continuity of life.

[57] Every partner, both general and limited, has a right to assign his interest in profits and capital (UPA Section 27 and ULPA Section 19; NYPL Section 53 and 108).

[58] See text at notes 40-42, *supra*.

[59] Unless an assignee becomes a substitute limited partner, he has no right to an accounting or to obtain any information or inspect the partnership's books (ULPA Section 19; NYPL Section 108). Presumably, he does not have a right to vote on any matters which require the consent of the limited partners.

[60] See Reg. Section 301.7701-3(b)(2), *Examples (1)* and *(2)*. This may represent a change from prior law. See *Glensder Textile Co.*, *supra*, which indicates that corporate free transferability does not exist even though the limited partners had the power to designate their assignees as substitute limited partners.

[61] ULPA Section 19; NYPL Section 108. In such cases, the consent of *all* members is required to enable an assignee to become a substitute limited partner. However, partnership agreements often require the consent of any or all of the general partners. At least where the consent of all the general partners is required, free transferability does not exist (Reg. Section 301.7701-3(b)(2), *Examples (1)* and *(2)*). Presumably, the necessity of obtaining the consent of any one of the general partners would also preclude the existence of free transferability.

[62] Reg. Section 301.7701-2(e)(2).

[63] Reg. Section 301.7701-2(a)(1).

[64] The references to number of members in each example in the Regulations leads one to speculate that, at the time these examples were drafted, numbers may have played a part in classifying the hypothetical organizations.

[65] The final Regulations do observe, however, that centralized management is more likely to be found in an organization with many members. Reg. Section 301.7701-2(c)(1).

[66] Reg. Section 301.7701-3(b)(2), *Example (2)*.

[67] Note that the partnership in this example has two of the four major corporate characteristics. See text at notes 69 and 70, *infra*.

[68] Thus, the court in the *Glensder* case, *supra*, stated: "It does not appear that [transfers of limited partnership interests] were contemplated, for no mechanics were provided for the ready transfer of interests through certificates representing shares in the partnership." (46 BTA at 196)

[69] Reg. Section 301.7701-2(a)(3); Reg. Section 301.7701-3(b)(2), *Example (2)*. Characteristics common to partnerships and corporations, namely, associates and an objective to carry on business and divide the gains therefrom, are not considered in making this determination.

late to free transferability of interests; the two other factors mentioned would relate to continuity of life. Since the Regulations fail to consider that the three mentioned factors are material in determining the existence of these major corporate characteristics, they should not be significant as other factors. Any other approach would defeat the purpose of the Regulations by allowing uncertainty of result to creep in through the back door.

Balancing of characteristics

The Regulations provide that an organization will not be classified as an association unless it has more corporate characteristics than noncorporate characteristics. Thus, a limited partnership which has centralized management and free transferability of interests but lacks continuity of life and limited liability and which has no other significant characteristics will be classified as a partnership.[69] Presumably, the lack of any two of the four major characteristics (assuming no other significant factors) would suffice to avoid classification as an association. This would seem to represent a change from the prior Regulations under which a limited partnership would be classified as an association only if both continuity of life and centralized management existed.[70]

Note that the numerical weighting appears to be an absolute rule: an organization *shall not* be classified as an association *unless* a majority of its characteristics are corporate characteristics. This raises a question as to the role played by the so-called other significant characteristics. Apparently these factors may be either corporate characteristics or noncorporate characteristics. In fact, if a particular factor were a corporate characteristic, it would seem that the absence of that factor would be a noncorporate characteristic. Otherwise, the factor could hardly be "significant." If the numerical weighting encompasses these other factors, it would be essential to determine the exact number of the other factors that would be significant if present. Those that are present would be corporate characteristics; those that are absent would be noncorporate characteristics. However, it would seem that such a result is not contemplated by the Regulations. The numerical weighting presumably is intended to provide certainty in classification of an organization. To inject unspecified other factors would defeat the purpose of the numerical weighting.

One possible interpretation of the Regulations that would eliminate this difficulty is that the reference to additional factors was intended only to negate classification as an association. This finds support in the fact that the Regulations state a numerical weighting only to indicate when an organization will not be classified as an association; the converse is not stated.[71] However, the foregoing illustration of the limited partnership having two of the four major corporate characteristics is inconsistent with this approach, since it expressly assumes that no other significant characteristics are present.

A more likely explanation may be that the Treasury did not have any particular factors in mind but was merely trying to avoid taking too inflexible a position in the event unforeseen situations should arise. Under this view, the ultimate test under the Regulations is the subjective test of whether an organization's characteristics are such that it more nearly resembles a corporation than a partnership. The numerical test, considering only the four major characteristics, would create a strong presumption that an organization does or does not more nearly resemble a corporation than a partnership. However, this presumption could be overcome by the presence of "other significant factors."

Another related problem is the distinction between modified and unmodified free transferability. The Regulations state that the modified version is to be given less significance.[72] This was meaningful in the proposed Regulations, which apparently used a subjective test only. However, if the final Regulations adopt a numerical weighting as the sole test, the significance of this distinction is obscure, even if the modified form is treated as one-half a characteristic. For example, if the organization lacks two out of the three remaining major characteristics, it will not be classified as an association, whether or not the the free transferability exists in modified form. On the other hand, if the organization lacks only one of the other three major characteristics, it would seem to be classified as an association, whether or not the free transferability is modified.

The answer may be as suggested above. In the absence of other significant characteristics, the distinction between modified and unmodified free transferability is meaningless. However, if these other factors exist, so that a subjective test comes into play, the distinction might be significant.

The final Regulations are applicable only to taxable years beginning after December 31, 1960.[73] However, any amendments of the agreement establishing the organization will be considered to have been in effect as of the beginning of such taxable year if (1) the amendment is made before October 1, 1961, and (2) the amendment would not change the classification of the organization as of November 17, 1960, the date of publication of the final Regulations.[74] The addition of this "grace period" was strenuously urged by the Association of Real Estate Syndicators.

The proposed Regulations merely stated that the rules provided therein would be applicable to taxable years beginning after the date of publication of the final Regulations.[75] It was felt that there was sufficient ambiguity in the proposed Regulations to raise ques-

Analysis of new mining Regulations available

EVERY TAXPAYER in the mining industry must by May 1, 1961, make important and irrevocable decisions that will govern the determination of the property upon which depletion is computed. The recently issued final Regulations under Section 614 of the Code, which control these property decisions, have been analyzed in a lengthy memorandum prepared by Brice O'Brien and Laurence P. Sherfy of the American Mining Congress. Copies of this memorandum can be obtained by writing to the American Mining Congress, 1102 Ring Building, Washington 6, D. C. ☆

[70] Reg. 118, Section 39.3797-5. Similarly, if either of these two "essential" characteristics were lacking, a limited partnership would be classified as a partnership under prior Regulations. Under the final Regulations, it would appear that a limited partnership could be classified as an association even though *both* of these two essential characteristics are lacking, if other significant factors are present; it could also be classified as a partnership if *both* of these essential characteristics were present.

[71] One such factor which had been submitted to the Treasury for consideration by the Association of Real Estate Syndicators was the existence of substantial limitations upon the managers' control over distributions of profits and capital.

[72] See text at note 62, *supra*.

[73] Reg. Section 301.7701-2(a)(4). Taxable years beginning before January 1, 1961, are governed by Reg. 118, Section 39.3797. See TD 6091, 1954-2 CB 47.

[74] *Ibid.*

[75] Prop. Reg. Section 301.7701-2(a)(3).

tions with respect to the classification of partnerships already in existence. The Association therefore argued that the final Regulations should provide a grace period during which existing partnership agreements could be modified with retroactive effect. They pointed out that the prior Regulations have been outstanding for over 40 years, in a form considerably different from the proposed Regulations, especially with respect to limited partnerships. During that period, taxpayers had properly relied upon the Regulations, opinions of counsel, and in some cases, private rulings.

The Association pointed to a similar situation in IT 3933 (1948-2 CB 130), modifying IT 3930 (1948-2 CB 126), relating to the classification as associations of oil and gas joint operating agreements. IT 3933 granted an adjustment period of 10 months because these agreements "involve a large number of persons, and that amendment of these agreements, as contemplated by IT 3930, will require substantially more time than is allowed by that ruling."

It is apparent that the Regulations now allow a greater degree of flexibility and certainty than was previously available to real estate syndicators. On the other hand, for the same reasons that a limited partnership does not qualify as an association, it does not offer all the business advantages of a corporation or trust. The absence of these advantages is the reason that so much interest has been generated in the real estate investment trust, which (if technical difficulties can be ironed out) combines the business advantages of a trust with some, but not all, of the tax advantages of a partnership. ☆

New decisions

Taxpayer sustained in his denial of family partnership. In 1951 taxpayer entered into the business of purchasing, warehousing, and selling fire bricks; at the same time he had papers drawn up creating trusts for his two minor children and a partnership for himself and the trusts. These papers were never signed. In 1952 taxpayer had his attorney draw up a partnership agreement for him and the children. He signed for them as guardian. He filed a "Business Certificate for Partners" in the county clerk's office. Taxpayer never filed partnership returns and individually claimed the full amount of 1952 and 1953 losses sustained by the business. The Commissioner contended that there was a valid family partnership and that taxpayer was entitled to only his partnership share of the losses. The court agrees with taxpayer. It holds that taxpayer may deny the existence of a partnership, since he never represented to the Commissioner, by filing partnership returns, that the business was operated as a partnership nor did he derive a tax benefit from any claim that the business was a partnership. The court recognizes that the validity of a family partnership depends on all the facts. Here the children performed no services and contributed no capital (the trusts that would have furnished the capital were never created). The children could not be considered as partners in the business. *Bialock*, 35 TC No. 70.

Purchase of partner's interest in partnership property did not increase partnership's basis. (Old law) A partnership purchased for $70,000 one of the partners' interest in certain partnership securities. This selling partner, however, retained his interest in other partnership property. Taxpayer, another partner, who was then entitled to all of the partnership income, claims that the Code allows an allocation of the purchase price to the partnership securities, thus giving them a stepped-up basis. The Tax Court ruled that, since no new assets were actually acquired by the partnership in the purchase, there is no reason to disturb the cost basis of specific partnership assets. However, the Tax Court findings as to the continued existence of the partnership and the contractual arrangements among the partners were too incomplete for this court to review the issue. It remands for more complete findings. [The 1954 Code provides specific rules for the treatment of basis of remaining assets when a partner's interest is purchased by the partnership.—*Ed.*] Similarly, the right of taxpayer to deduct real estate taxes paid on partnership property depends on more adequate fact findings. *Miller*, CA-10, 11/16/60.

Partner's estate, all to charity, can deduct only net of final year's income after drawings during life. A partner in a New York law firm provided in his will that the residue of his estate be held in trust, the income to be paid for life to his sister, and the remainder to Harvard College. Upon his death, the estate sought a charitable deduction for the full amount ($35,000) of the partner's distributive share of income from his law partnership for the year in which death occurred. Noting that the full year's distributive share of the partner had not actually been received by the estate because the partner drew most of it out of the partnership before his death, the Tax Court allows as a charitable deduction only the remainder of the year's distributive share actually paid to the estate. This amount was allocable to the corpus of the testamentary trust under local law. Section 642 of the 1954 Code allows a deduction for any amounts of gross income of an estate paid or permanently set aside for charitable purposes. The amount paid to the partner during his life was not available to be set aside by the estate for charitable purposes. That the full distributive share was includable in the gross income is immaterial. *Sanford H. E. Freund Estate*, 35 TC No. 67.

New state & local decisions

Spin-off dividend of stock of new corporation not income. A Mississippi corporation set up a new corporation, transferred to it all the assets of one of its departments, took back stock of the new corporation of a par value equal to the book value of the assets transferred, and distributed such stock pro rata to its own stockholders. The State Tax Commission asserted that such distribution constituted income to such stockholders under state law. This court disagrees, since it was "unable to conclude that the transaction here involved resulted in any 'actual gain' or 'increase of wealth in hand' to the stockholders." It held that "The income of the stockholders . . . was neither increased nor diminished by the transaction." In a discussion, perhaps rendered more obscure by what appears to the erroneous inclusion of the word "not" in a crucial sentence, the court held that the distribution constituted a stock dividend within the meaning of the applicable Regulations and also, apparently, that the distribution was of the corporation's own stock "of like class of stock as the stock on which the dividends are declared." *Hogg*, Sup Ct. Miss., 11/14/60.

THE TAXATION OF INDIVIDUALS

Personal tax problems

EDITED BY HAROLD OELBAUM, LL.M.

Gift between declaration and record dates makes dividends taxable to donor

by HAROLD OELBAUM

ONE AREA WHERE THE RULES have long seemed clear is the determination of the party to be taxed on dividends paid in cash. The Tax Court in *Anton* (34 TC No. 86 (1960)),[1] now on appeal to the Third Circuit, has, despite efforts of the Tax Court to limit its decision, cast doubt over the entire area.

In the *Anton* case, the taxpayers were the controlling shareholders in a personal holding company. In order to offset personal holding company surtax, a deficiency dividend was declared on April 17, payable on May 10. The taxpayers on May 9 gave some of their stock to their children. The children were the stockholders of record on the record date. The corporation paid the dividend as declared.

The Commissioner contended that the dividends were includable in the taxpayers' income rather than in the children's income. The Tax Court agreed.

The court stated that, under New Jersey law, declaration of the dividend created a debtor-creditor relationship between the corporation and its then stockholders. It followed, therefore, that under the doctrine of *Helvering* v. *Horst* (311 U.S. 112 (1940)) the transfer of stock and the right to secure a dividend to which the transferor was entitled did not relieve the transferor of the obligation to include the dividend in gross income.

The court carefully stated, in an effort to limit the effect of its decision:

"The principles applicable here are not comparable to those governing taxability of a dividend declared before but paid after an arm's-length sale of the stock or to those governing the taxability of a dividend declared before but paid after the death of the owner."

It is, of course, true that the basic relationships of the parties involved is properly determined by looking at applicable state law—here, New Jersey. Nevertheless, the fact that stockholders as a class, for certain corporate law purposes, are treated as creditors of the corporation after the declaration date should not be determinative in a tax case where the relationships of the parties are examined for quite different purposes. It would be intolerable to find that dividends are to be taxed differently from state to state.[2]

Although it is beyond the scope of this article to carefully examine New Jersey law, it does appear that no individual stockholder has, under New Jersey law, any vested right to a dividend until the record date. Regardless of how one views New Jersey law, it is hard on principle to distinguish the situation where stock is sold between the declaration and record dates from that where it is given away between such dates.

The rules as to stock sold are correctly stated in Regs. Section 1.61-9(c), which provides, in part:

"When stock is sold, and a dividend is both declared and paid after the sale, such dividend is not gross income to the seller. When stock is sold after the declaration of a dividend and after the date as of which the seller becomes entitled to the dividend, the dividend ordinarily is income to the seller. *When stock is sold between the time of payment of the dividend, and the sale takes place at such time that the purchaser becomes entitled to the dividend, the dividend ordinarily is income to him. . . .*" (Emphasis supplied)[3]

The court did not explain why the above stated rules as to sales did not apply in a gift situation. It stated that "the question here is whether a father can avoid Federal income tax after a dividend has been declared by giving his stock to children just before the record and payment date." That same question arises in sale situations as well as in gift situations. It is, of course, today indisputable that there is nothing wrong in managing one's affairs so as to avoid taxes, so long as the transactions involved are real. Here the fathers divested themselves of ownership of the "tree" just before its "fruit" was ripe. This was a real transaction. The fathers retained no strings on the donated stock.

The court relied on the *Horst* case. In *Horst* a taxpayer detached interest coupons from bonds prior to maturity and gave only the coupons to his son. The Supreme Court held that, since he realized economic satisfaction from the transaction and had retained ownership of the property that gave rise to the income, the interest income was properly includable in taxpayer's gross income. It is significant that *Horst* was an example of separating the "fruit" from the "tree." No responsible tax man would today agree that assigning the rights to future dividends (the fruit) without assigning the stock (the tree) relieves the assignor of tax on such dividends. In *Anton*, however, the property that gave rise to the dividends was also transferred.

Of course *Horst* is not to be limited to its facts; it is but one of many cases establishing broad principles to be used in determining the proper party to be taxed. It has long been settled that income derived from property shall normally be attributed to the person who owns the property. Thus, property transferred subject to the right of the grantor to revoke is treated as owned by the grantor, and income therefrom is taxed to the grantor (*Corliss* v. *Bowers*, 281 U.S. 376 (1930)). Similarly, if property is irrevocably transferred but the income therefrom is to be applied to the discharge of the assignor's obligations, the assignor would be taxed on such income (*Douglas* v. *Willcuts*, 296

[1] The decision was not reviewed by the whole court.

[2] Compare the handling of state law in *Putnam's Estate* (324 U.S. 393 (1945)), dealing with the question of whether a dividend was income to a decedent or his estate. The Board of Tax Appeals had relied on state law to determine when a corporate debt arose. The Supreme Court rejected the view that such state law considerations governed the case before it.

[3] It should be noted in considering *Anton* that dividends are income to taxpayers when paid, whether the taxpayer is on the cash or the accrual basis. This is primarily based on the fact that the distributee is not known at the declaration date, and a recipient of a dividend may be on a cash basis while the holder on the declaration date may have been on the accrual basis. (See, *e.g.*, *American Light and Traction Co.*, 156 F.2d 398 (CA-7, 1946); *Beneficial Corp.*, 18 TC 396 (1952), *aff'd* 202 F.2d 150 (CA-3, 1953).)

[*Harold Oelbaum is the editor of this department and the Assistant to the General Tax Counsel of the Raytheon Company, Lexington, Massachusetts.*]

U.S. 1 (1935)). And if property remains subject to the control of the assignor, the income therefrom is taxed to the assignor (*Helvering* v. *Clifford*, 309 U.S. 331 (1940)). None of these landmark decisions establishes any principle that applies to the fact situation in *Anton*, where in a real transaction property carrying with it the right to income was irrevocably transferred with no retained strings. (*Cf.* also *Lucas* v. *Earl*,, 281 U.S. 111 (1930); *Burnet* v. *Leininger*, 285 U.S. 136 (1932); *Helvering* v. *Eubank*, 311 U.S. 122 (1940).)

The mere fact that tax is avoided does not change the basic rule that income is taxed to the owner of the property. Nor is donation an event that results in the realization of income. (See *e.g. Farrier Estate*, 15 TC 277 (1950); *SoRelle*, 22 TC 459 (1954); *Rev. Rul.* 55-138, 1955-1 CB 223; *Rev. Rul.* 55-531, 1955-2 CB 520.)

The principles involved in the assignment of income cases often equally apply in cases concerned with sales of assets, with the question being whether ordinary income or capital gain is realized. An elementary example is *Rhodes Estate* (131 F.2d 50, CA-6, 1942), where a stockholder who sold a right to a declared dividend after the record date was held to have ordinary income.

The taxpayers in *Anton* argued that, since the fruit as well as the tree had been given away, the dividends were taxable to the donees. It seems clear that they were correct. It is hard to attribute such significance to the court's reliance on New Jersey law, since, if the basis of the decision was that the donor had a right to the dividend before he transferred it, a vendor of the same stock under the same circumstances should similarly be taxed on the dividend. Since the court specifically held that the sale situation was distinguishable, it must have based its decision on notions of tax avoidance. The cases dealing with assignment of income do not support the court's decision in *Anton*.

Where does *Anton* leave us? It is possible that it will be limited to cases dealing with deficiency dividends paid by personal holding companies.[4] It would seem that the court's principal reason for stretching notions arising in the assignment of income case was the ease by which the taxpayers avoided personal holding company surtax. Any restrictions on the identity of persons to whom deficiency dividends may be paid is a matter within the legislative rather than the judicial province. If this analysis of the court's motives is correct, it is to be criticized for indirectly reaching a result, however justified, in a fashion that could have far-reaching effects. Or *Anton* may be applied to dividends paid by any close corporation. Theoretically, of course, it should not be significant how closely a corporation is held.

It would seem that *Anton* can be avoided by simply making the gift prior to declaration. If so, there is a potential contrary argument that the principle of *Anton* applies even if the gift is made before declaration of a dividend by a closely owned corporation if declaration was "planned" prior to the gift. (In general, *cf. Hyland*, 175 F.2d 422, CA-2, 1949 and *Kunze*, 19 TC 29 (1952) *aff'd* 203 F.2d 957, CA-2, 1953, to *Cooney*, 18 TC 883 (1952)).

If *Anton* is to be limited to gifts of stock in a closely held corporation, query if it applies only to inter-family assignments or would it also be applied on donation of stock to charity. The great and perhaps inequitable tax benefits resulting from charitable giving have, of course, been the subject of much controversy and litigation. It is unlikely that a "loophole"-minded new administration will fail to use all of the available tax weapons. There does not seem to be any valid reason why the reasoning of *Anton* could not be applied to the charitable gift situation. On the other hand, most charities and substantial charitable givers are sufficiently tax-sophisticated to arrange their affairs to avoid coming under the rule now created by *Anton*.[5]

Thus, we now have a different rule for taxability of dividends between gift and sale transactions. As long as *Anton* is still on the books, it can lead to much confusion and uncertainty. It appears to have been a totally unnecessary decision, as it probably can, as a general rule, easily be avoided by knowledgeable tax planners. *Anton* appears to be an example of a court yielding to the temptation of reaching a result that it considered equitable and then straining to justify its decision. *Anton* is incorrect and should be overruled. ☆

[4] *Cf. Rev. Rul.* 60-331, 1960-43 IRB 20, where a corporation was set up solely for the purpose of receiving a deficiency dividend from a personal holding company. This was held to be a sham transaction on the basis of *Gregory* v. *Helvering* (293 U.S. 465 (1935)) and *Higgins* v. *Smith* (308 U.S. 473 (1940)). The transfers in *Anton* would presumably not be subject to attack as sham transactions.

[5] Also, the principles developed in the assignment of income cases are not limited to dividend situations; *Anton* may be relevant to varying degrees to an enormous number of transactions. It is not a decision to be lightly dismissed.

New decisions affecting individuals

★***Railroad conductor can deduct traveling expenses away from home.*** This controversy arose over the disallowance of a railroad conductor's income tax deduction of expenditures for lodging, meals, and tips as "traveling expenses" during six-hour lay-overs "away from home" on regular trips, each trip requiring the absence from his home terminal of about 16 hours. The Government argued that, since the taxpayer was not ordered by his employer to use his free time for sleep and rest and his absence from his home terminal was not substantially longer than an ordinary work day, no deduction should be allowed. This court holds: "If the nature of the taxpayer's employment is such that when away from home, during released times, it is reasonable for him to need and to obtain sleep or rest in order to meet the exigencies of his employment or the business demands of his employment, his expenditures (including incidental expenses, such as tips) for the purpose of obtaining sleep or rest are deductible traveling expenses under Section 162(a)(2) of the 1954 Code." *Williams*, CA-5, 1/12/61.

Tax Court applies Harvey test to away-from-home expenses; expenses on two-year job disallowed. Taxpayer resided in Savannah and worked as a paymaster for a construction company. His firm sent him on a construction job to a site 166 miles from his permanent home. It estimated that the job would be completed in about 10 to 11 months. Additional contracts were obtained at the job site, so that taxpayer actually remained there for over 25 months. While at the job site, taxpayer lived in a hotel and sought to deduct the cost

of his food and lodging during the entire period as travel expenses away from home. The court holds the expenses were personal living expenses and not deductible because there was a reasonable probability known to taxpayer that his employment at the job site would last long enough to warrant moving his family there. However, similar expenses on a rush order to do a specific job that lasted for six months are held deductible, since termination of that job could be foreseen within a fixed or reasonably short time, and there was little probability that it would last for a long period of time. *Stephenson,* TCM 1961-27.

Dutch elm disease of trees not casualty. The court holds, affirming the district court, that the loss occasioned by the complete destruction of trees on taxpayer's property due to Dutch elm disease is not a casualty. It is a fungus spread by beetles, and its spread to the trees lacks the element of suddenness characteristic of a casualty. *Burns,* CA-6, 12/10/60.

Victim of business swindle allowed theft deduction. [*Acquiescence*] Taxpayer, an unsuspecting woman, advanced $28,000 to a man who promised to invest the money for her in his businesses. When the businesses failed, taxpayer brought civil suit to recover the money on the ground that it was secured under false pretenses. The borrower admitted this and allowed judgment to be entered against him. Taxpayer, unable to collect the judgment, claimed a theft loss deduction of $28,000 and was sustained by the Tax Court. Noting that local law governs the question of whether there has been a theft loss, the court concluded that the taking of money under false pretenses (as admitted by the borrower) constitutes theft under California law. The fact that a later criminal indictment against the borrower was dismissed for lack of reasonable or probable cause does not affect the result. A conviction for theft is unnecessary where the circumstances otherwise clearly indicate that the loss was occasioned by theft. *Monteleone,* 34 TC No. 73, *acq.,* IRB 1960-50.

Failure to prove wagering losses. In the first appeal of this case, this court reversed because of its dissatisfaction with the findings of the Tax Court and sent the case back to make new findings. Upon a second review, the case was remanded to the Tax Court to receive further evidence. When before the Tax Court for the third time, the petitioner failed to introduce new evidence, and the Tax Court determined the deficiencies to be the same as previously decided. This court holds that, therefore, the record last before the Tax Court fails to furnish guidance to support the petition for redetermination. The taxpayer's burden of proof was not met, and the decision of the Tax Court is affirmed. *Schowell,* CA-9, 1/9/61.

Dependency exemption denied for failure of proof. A father, by court order, was required to pay a weekly sum for the support of his wife and minor child. No allocation between wife and child was spelled out. The court denies the father a dependency exemption for the child in the absence of proof that he provided over half of his child's support. *Wollar,* TCM 1961-14.

Fair rental value of house occupied by dependent considered in determining total support. A son contributed $1,200 toward the support of his mother. The mother had a railroad retirement pension of $720, which she expended in her own support, and was also the sole owner of the house in which she lived. It had a fair rental value of $780. The court holds the fair rental value of the house must be included in computing the mother's total support. Accordingly, her total support was $2,700 of which the son contributed less that half, and he is denied the dependency exemption. *Bielawa,* TCM 1961-2.

Basis for New Mexico property held as tenants in common. A husand and wife in New Mexico, which is a community-property state, orally agreed that in their contemplated business ventures they would share profits equally and hold any property purchased with the profits as tenants in common. During 1943 and 1944, each made gifts to their son and daughter, filing gift tax returns which claimed that the gifts originated in equal parts from their separate property. Deficiencies in gift tax were assessed on the ground that the then controlling decisions in the state of New Mexico forbade transmuting community property into separate property by mere agreement of the parties. When the husband died in 1951, the estate tax return listed all the property in question as community and included one-half of the whole of the community property in determining the value of the gross estate. Consistent with the gift tax treatment of the property as community, the Commissioner disallowed one-half of the administration expenses and debts. Subsequently, the Supreme Court of New Mexico overruled its earlier decisions and held that a husband and wife could, by agreement, transmute separate and community property. Thereafter, by this case, the Commissioner challenged the wife's basis in certain property sold by her in 1952 and 1953, saying that the property had been held by her and her husband as tenants in common, which did not give her a stepped-up basis upon the death of her husband. The Tax Court agreed with the Commissioner, and this court affirms. The agreement to hold all their property as tenants in common was valid from its inception, despite the fact that such agreements were not recognized in New Mexico until the Supreme Court reversed its prior decisions. The taxpayer cannot assert an estoppel against the Government. *Massagalia,* CA-10, 1/3/61.

Wife's overpayment offset against husband's deficiency in community property state. Under Hawaiian law, income taxes of a spouse were debts or liabilities for which community property was chargeable. Taxpayer used funds from the sale of community property to pay her income tax. The Court of Claims permitted the Government to offset a refund due her against an income tax deficiency owed by her against an income tax deficiency owed by her husband. *Santos, cert. den.,* 12/5/60.

ALIMONY

Alimony deductible even though husband receives stock under separation agreement. [*Acquiescence*] In their separation agreement, taxpayer agreed to pay his wife a fixed monthly allowance for her maintenance and support until she received certain insurance payments, which would become due on the death of one with a prior life interest. Taxpayer's wife, in return, agreed to convey to taxpayer certain stock she held in the family corporation; she also agreed, in the event of a divorce, not to apply for alimony. Taxpayer and his wife were subsequently divorced. Taxpayer made payments pursuant to the agreement and deducted the amounts paid. The Com-

missioner disallowed the deduction on the ground that the payments were imposed not because of the marital relationship but rather as consideration for the stock. The Tax Court held that the periodic payments are deductible and found that the conveyance of this stock to taxpayer was motivated by non-monetary considerations, particularly a desire to keep the stock within the family. Further, the separation agreement, being in terms of "support and maintenance," manifests the parties' intention that the payments be for support. The fact that the payments would probably stop when the periodic payments approximate the value of the stock transferred is not, the court concluded, determinative. *Blate,* 34 TC 121, *acq.,* IRB 1961-4.

No gain on relinquishment of option in divorce settlement. In 1937 taxpayer gave his wife certain stock but retained an option to repurchase it for $40,000. In a divorce settlement in 1951, when the stock was worth $400,000, taxpayer released his option in exchange for his wife's giving up her support rights. The Tax Court found, with three dissents, that the husband realized a long-term capital gain from the disposition of his option in the amount of $360,000. Refusing to follow *Mesta* (123 F.2d 986, *cert. den.* 316 U.S. 695), the Sixth Circuit reversed. The wife's rights to maintenance and support and to share in the husband's estate were too uncertain to be given a fair market value. A property settlement in a divorce proceeding usually involves considerations that play no part in a transaction between a willing seller and a buyer in the open market. A dispute about the validity of the option is another factor against fixing its fair market value. *Marshman, cert. den.,* 12/12/60.

Settlement agreement imposed alimony liability; 10-year test is met. Taxpayer's divorce action was heard on January 19, 1952, and on that day the divorce court adopted a settlement agreement dated January 17, 1952, providing for payments of $300 per month to his wife. If the decree of divorce dated January 19 imposed the legal obligation for periodic payments upon the taxpayer, the payments were not deductible from his gross income because they were not to be paid for a period "ending more than ten years" from the date of the decree. But if the settlement agreement, dated January 17, imposed the obligation, the payments were taxable income to the divorced wife and deductible by the taxpayer as alimony. The Tax Court held that the divorce decree established the legal obligation and, thus, that the taxpayer was not entitled to a deduction for alimony. This court reverses the Tax Court. In Missouri and elsewhere, a husband and wife, in contemplation of separation and divorce, may, by valid contract between themselves, settle and adjust all property rights growing out of the marital relation. The pre-divorce contract or settlement was simply approved and incorporated in the divorce decree. This court thinks that under state law it was the settlement agreement that imposed the obligation upon the taxpayer to pay $300 monthly to his divorced wife and not the divorce decree entered two days later. *Spicknall,* CA-8, 1/11/61.

WHAT IS INCOME

Scholarships in excess of limits are taxable but no withholding is required. Scholarships to those who are not candidates for a degree are nontaxable only to the extent of $300 a month for not more than 36 months. The IRS now rules that scholarship payments in excess of these limits are taxable income of the recipient but they are not income from self-employment and so are not subject to that tax nor are they wages subject to withholding. *Rev. Rul.* 60-378.

Railroad employee's damage settlement not income, though part was allocated to time lost. Taxpayer, a railroad employee, was injured and was unable to work for a while. He entered into a settlement agreement with the railroad and received a payment on his claim for damages. For the purpose of computing his railroad retirement credit, he allocated part of the damages to reimbursement for time lost. The IRS rules that, despite this allocation, the payment was damages for personal injuries and is not taxable. *Rev. Rul.* 61-1.

Cost-of-living allowances of service men abroad not taxable, even though paid by foreign governments. Members of the armed forces of the U. S. stationed abroad and training nationals of foreign countries are paid cost-of-living allowances by the foreign governments. The IRS rules that they are not taxable. The Regulations provide that quarters and subsistence allowances paid by the U. S. Government are not taxable. Here, too, the allowances are not intended as compensation but solely to insure against financial loss in undertaking foreign service. The fact that the allowance is made by the foreign government, under agreement with the U. S. Government, does not change the noncompensatory character of the payment. *Rev. Rul.* 61-5.

Escrowed portion of proceeds not income on cash basis. Taxpayer sold her contingent remainder interest in real estate along with the life tenant's interest. To protect the purchaser in the event of taxpayer predeceasing the life tenant, a portion of the sales price was withheld from taxpayer and was used to buy insurance on her life. The policy was placed in escrow. If taxpayer in fact survived the life tenant, the policy would be paid to her. The court holds that the portion of the sales price thus withheld is not income to taxpayer in the year of sale. Although she will eventually receive this amount, the future right is not the equivalent of cash. *Axe,* DC Kan., 1/13/61.

EXPENSES

Bulk of travel, entertainment, club dues, and insurance premium disallowed. Taxpayer was sole proprietor of a car-washing business. He claimed business expense deductions for (1) travel expenses for a trip taken with his wife and children in which he visited various car-washing plants (the Commissioner allowed part of the expense claimed), (2) entertainment expense and club dues, and (3) premiums on an insurance policy on his life, taxpayer having retained all rights of ownership in the policy. Taxpayer claimed the policy was required in connection with a business loan. The court (1) disallows the bulk of his travel expenditure as not proved business expenses and allows only what the Commissioner allowed (taxpayers wife's and children's expenses are not allowed), (2) allows a part of the entertainment expenses under the *Cohan* rule (but disallows the club dues as too remote from a business purpose), and (3) disallows the insurance premiums as a clear example of a personal expense (taxpayer's claim that the policy was required in connection with a business loan being rejected). *Guglielmetti,* 35 TC No. 72.

Mardi Gras expenses and parade horses not allowed as advertising expenses. A taxpayer in the safe and lock business is denied a business deduction for the bulk of expenses incurred on account of Mardi Gras activities and for the cost of maintenance of parade horses. There was no showing that advertising material was used in connection with the parades or shows that would publicize his business. The mere fact that membership in social and other organizations is helpful in providing contacts and obtaining clients is not sufficient to justify deduction of the expenses in connection therewith as ordinary and necessary business expenses. A claim that the cost of maintaining the parade horses should be allowed as a charitable contribution because of their use in local parades is summarily dismissed. The Tax Court is affirmed. *Rolland,* CA-5, 1/17/61.

Diary accepted as substantiation of travel expenses. Taxpayer was a manufacturer's representative who traveled extensively in his own auto selling glass products on commission. The bulk of his traveling expenses were paid in cash and were recorded daily in a diary. He relied almost entirely upon this diary to substantiate his deduction. The court accepts the diary as an adequate form of substantiating travel expenses, pointing out that the Commissioner, in his own rulings, seems to recognize that travelers have to make cash expenditures that will be considered substantiated if properly recorded. The taxpayer appeared *pro se;* he was allowed expenses of $7,248 against income of $8,919. *Weinfeld,* TCM 1961-17.

Forfeiture of deposit on house a personal loss. The forfeiture of a deposit on the purchase of a house in an area where taxpayer hoped to obtain employment is a loss purely personal in nature and nondeductible. *Krych,* TCM 1961-11.

Can't deduct trips from home in France to settle property here. Taxpayer resided in France and made frequent trips to the U. S. in connection with the administration of her husband's estate, dealing with the Alien Property Custodian, and negotiating with respect to the sale of property in New York in which she had an interest. She claimed the cost of these trips as travel expenses. The court denies the deduction, holding that if taxpayer were engaged in any trade or business, either as executrix or as a manager of the New York property, the location of such business was in New York. Taxpayer had no business interest in France. For this reason, taxpayer failed to establish that her travel expenses from France to New York and living in New York would constitute ordinary and necessary business expenses. Nor could the expenses be claimed as ordinary and necessary for the maintenance, conservation, and management of income-producing property. *Herter,* TCM 1961-19.

Unreimbursed expenses of union official. In the Tax Court, the taxpayer, a union official who asserted deductions on his Federal income tax returns for unreimbursed expenses in connection with his union activities was allowed a portion of those expenses. He weakened his case by indicating that a motive, at least in part, for some of the expense was the urgency of his being re-elected annually to his official union post. This court, in a *per curiam* opinion, affirms the decision of the Tax Court, saying that the case presented a fact question that cannot be retried in an appellate court. *Vernon,* CA-9, 1/19/61.

Bulk of doctor's expense for courses aboard cruise ship disallowed. A postgraduate medical seminar for doctors was conducted aboard a cruise ship en route to the Caribbean. A brochure, which advertised the cost of the trip as deductible, devoted one page to the medical courses and seven pages to the entertainment. The courses were given by five professors (who received a free trip) who normally were affiliated with a medical school, and the doctors received 25 postgraduate educational credits; equivalent courses were offered by medical schools at a smaller cost and in only four days. The ship was a regular passenger cruise ship not specially equipped for the teaching of medicine and it carried passengers other than the doctors. Taxpayer, a doctor, took the cruise and deducted $1,880, the cost of the cruise and return trip, as an educational expense. The Tax Court finds that the purpose of the trip was primarily personal and allows only $232 under the *Cohan* rule, since some professional benefit was derived from the courses. The court stresses that the ship was not specially equipped for the teaching of medicine, that equivalent cruises were offered at medical schools at a smaller cost and in four days, and that what taxpayer primarily sought was a vacation for himself. *Hoover,* 35 TC No. 60.

Unreimbursed travel expense not deductible by corporate stockholder. A corporate stockholder and director paid his own traveling costs incurred on behalf of the corporation without claiming reimbursement because of the poor financial condition of the corporation. The court denies the stockholder the deduction. Taxpayer's failure to claim reimbursement did not convert the corporation's expense to his expense. Furthermore, the sum of $137 paid by him as a dissolution fee and for unpaid franchise taxes of the corporation was not deductible, since there was no liability ever imposed on him for such payments. *Berner,* TCM 1961-23.

Horse farm was hobby. Taxpayer was a man of considerable means, deriving a large income from a successful construction business, as a dealer in building materials, ready-mix concrete, and asphalt paving, as well as other businesses. For the year 1953, he claimed a loss deduction in the operation of a horse farm. The Tax Court found that the farm was not a business in the year 1953 but was merely the continuation of a long-established hobby. This court affirms, saying that the record did not show the ultimate finding of fact made by the Tax Court was clearly erroneous. *McLean,* CA-4, 1/23/61.

Revenue Agent denied deduction for reimbursable auto expenses. An Internal Revenue Agent is denied a deduction for auto expenses where he failed to show they were not reimbursable. The fact that it was too much trouble to prepare the forms to seek reimbursement could not convert the expenditures into ordinary and necessary business expenses of his own. *Krych,* TCM 1961-11.

Cattle operation intended for profit, not hobby. On the evidence, the court concludes taxpayer engaged in a cattle operation for profit and not as a hobby. All of the ordinary and necessary expenses of the farm are allowed as business deductions. The farm was not a show place, and there was no evidence that it was used primarily for entertaining or relaxation. *Dickerson,* DC Tex., 11/21/60.

TAX STRATEGY, NEWS OF THE REVENUE SERVICE

Effective tax procedures

EDITED BY MARTIN M. LORE, LL.B., CPA

Negligence penalty seen as new hazard in careless T&E reporting

THE TREASURY'S NEWEST WEAPON in its attack on the expense account is an old sword in a new sheath. The 5% penalty imposed by Section 6653(a) of the Code upon a deficiency, any part of which is due to "negligence or intentional disregard of rules and regulations (but without intent to defraud) . . .," is nothing new to tax men, but its application in the expense account area is a recent development. It is now reported that the Treasury has instructed its Agents in the field that the penalty is to be applied if the taxpayer's records are considered inadequate.

The negligence penalty has traditionally been asserted in cases of sloppy bookkeeping and accounting. Many cases have upheld the Commissioner's assessment of the penalty where deductions were disallowed because of inadequate proof. That the expense account is vulnerable to this attack should be clear.

The penalty can also be applied, as a recent Tax Court decision makes clear, where the taxpayer helps himself to a deduction to which he knows (or should know) he is not entitled under the law. *Farwell* (35 TC No. 54, (1960)) should serve as a warning and a reminder to tax advisers of the relevance of prior years' experience with Revenue Agents dealing with a challenged item. Felix Farwell and two brothers owned improved real estate subject to an existing lease. They employed a real estate broker to negotiate a new lease, and for 1952 each deducted one third of the broker's commission paid in that year. When Farwell's return was audited in 1954, the Service insisted that the payments be amortized over the term of the lease, and the taxpayer agreed. For 1954, however, he deducted the disallowed portion of the 1952 deduction. In the Tax Court case he was contesting the Commissioner's assertion of negligence penalty against his entire 1954 deficiency, because of the deliberate disregard of rules and regulations, by claiming a nondeductible item.

The Tax Court, after reviewing the testimony of the taxpayer that he had in fact agreed to the 1952 adjustment, stated:

"Aside, however, from the question whether the full amount was deductible in the year paid or properly should be amortized, the fact remains that Felix knew, of course, that he did not not expend this amount in the year 1954."

Pointing out that a basic principle of the cash method of accounting is that deductions must be taken in the year of payment, the court said, ". . . it would seem probable that Felix was aware of this principle." The fact that the item was deducted with the explanation "realtor's charges" indicated no intent to "hide" the item on the return, and the Commissioner did not so assert. "However, we do not think this is determinative. The resultant underpayment might still be due to negligence or intentional disregard of rules and regulations." The court then went on to point out that the taxpayer has the burden to show the Commissioner's error in asserting this penalty.

Another point the court mentioned is that, like the fraud penalty, the negligence penalty of Section 6653(a) applies to the entire deficiency if any part thereof is due to negligence or the intentional disregard shown in this instance. Thus a very small part of a deficiency may result in a substantial penalty if there are other items involved.

Perhaps the most important aspect of the case is its possible application in areas of frequent abuse. Taxpayer here pretty clearly knew that he was not entitled to the deduction, but he went ahead and took it anyway. Many taxpayers take the attitude that such things are a sporting proposition: if they get away with it, fine; if not, they pay and they are out only what they would have paid in the first instance plus some interest. This is, of course often true in the expense account area, and it is in this area that many taxpayers have trouble year after year. Those whose deductions for particular items have been questioned repeatedly and disallowed in some instances should be aware that subsequent repetitions may cause the invocation of the penalty. And if there are other items of deficiency, the cost can be very high, regardless of the nature of the other items.

As to the burden of showing error on the part of the Commissioner, affirmative demonstration must be made, presumably of a showing of due care and actual compliance with rules and regulations. In *Courtney* (28 TC 658 (1957)), for example, the court summarily disposed of taxpayer's contentions that the penalty should not be asserted: "No evidence regarding this matter has been introduced; therefore, the respondent's determination is upheld." ☆

Regulations include National Office technical advice

THE COMMISSIONER'S new amendments to the procedural Regulations are for the most part of a highly technical nature (one, in fact, simply amends Regs. Section 601.105(d) to change the word "triplicate" to "duplicate" in describing how many copies of protests must be filed), but two are of a bit more general interest. These deal with a new procedure for requesting technical advice from the National Office and with the representation of taxpayers before the Treasury.

Regs. Section 601.105, which deals with audit of returns by the office of the District Director, was amended on December 28, 1960, to add a new subsection (5), "Technical Advice from the National Office." This provides that, where the District Director decides that an issue requires technical advice from the National Office, the taxpayer will be advised of the proposed referral. The taxpayer will then have an opporunity to submit a brief, which will then accompany the case to Washington. Similarly, the taxpayer can request referral ". . . on the grounds of lack of uniformity or that the issue is so unusual or complex as to warrant National Office consideration." If the examining office (or informal conferee) disagrees with the taxpayer as to the necessity of referral, the matter will be submitted to

the Chief, Audit Division, for decision. If he decides that the matter should not be referred, taxpayer will be advised of his decision.

Presumably, this procedure will be most often employed when the taxpayer has the idea that his Internal Revenue District is taking a position tougher than that of another district on a given issue. It doesn't appear too likely that taxpayers practising in one district will be too happy about advising the Agents of that district that the issue is too difficult or complex for them and that only Washington can decide it. But on the other basis, lack of uniformity, it is to be wondered how anxious the Audit Division, having made up its own mind about what the position on an issue should be, will be to ask the National Office for advice. Probably they feel that their own position is correct and, if there is any lack of uniformity, it is only due to the error of the neighboring district. Despite these drawbacks, the procedure offers sufficient flexibility to be employed to good advantage where a genuine doubt as to National Office policy exists on both sides, as well as a check to make sure that a particular district does not get too far out of line.

The other change in the Regulations amends Section 601.105(b)(1) to permit the representation of taxpayers by an unenrolled person who signed his return as its preparer during the audit of the return. This is subject to the limitations provided in Section 10.7(a)(7) of Dept. Circular No. 230.

These limitations (the Circular is published at 1959-1 CB 745) restrict the types of cases in which unenrolled persons may appear for the taxpayer and the levels of such appearances. They permit the unenrolled preparer to represent taxpayers before Revenue Agents or examining officers of the Audit Division but not at an informal conference in the District Director's office. No such representation is permited with respect to estate or gift taxes nor in connection with the return of a corporation, with one exception. This exception covers cases where one has prepared the individual returns of any of the officers of the corporation and has also prepared the corporate return for the same taxable period. In such a situation, the preparer may also represent the corporation. The fact that the return was not signed by the preparer, where the form provides no space for signature by such person, is of no importance. There is also the interesting provision that, where net operating loss carrybacks or carryforwards are involved, the preparer cannot deal with returns for prior or subsequent years unless he also signed them.

The newly promulgated Regulations simply acknowledge these changes, which were effected during 1959 by the amendment of *Rev. Proc.* 230. ☆

Rights to conferences on requested rulings clarified

THE IRS HAS RECENTLY emphasized that a taxpayer has a right to only one conference on his request for a ruling; an additional conference is scheduled only if the IRS takes a new position after the first conference or if it wants another conference. These rules are contained in an information release (TIR 288), the largest part of which deals with internal jurisdictional matters. However, the sections dealing with conference procedures are of interest to practitioners.

As in the past, the taxpayer requesting a ruling will normally be entitled to only one conference, generally at the branch level in the Tax Rulings Division. This conference will usually be attended by a person with the authority to approve the ruling for the branch chief. In order to make the conference "as fruitful as possible," it will not usually be held until the branch has had time to research the matter ". . . in order to isolate those points which may be bothersome in resolving the question presented . . ." and consider the competing lines of argument. The conference is to involve a free and open discussion of the issues presented, and the conferee will disclose the lines of reasoning ". . . which *might* lead the branch to rule adversely to the taxpayer's position." (Italics theirs.) But the taxpayer will not be informed at the conference of the final result that the branch will reach.

Following the conference, it will be the taxpayer's responsibility to add to the case file a written record of any additional data or legal reasoning he may have brought out orally at the conference. The taxpayer is to have a right to another conference at a higher level than the branch only if upon subsequent review (1) higher levels of the Service propose to take a position more detrimental to taxpayer than that taken by the branch, (2) they propose to decide the case on a new issue not raised by the branch, or (3) the Service itself decides it wants a new conference. Any second conference at a higher level will not be held unless the case has ". . . reached that stage where the *Service's* ultimate position has been tentatively reached."

As to conferences in the office of the Chief Counsel, the taxpayer, as in the past, is not entitled to a conference as of right on matters referred there by the Office of the Assistant Commissioner (Technical). If such a conference is scheduled, a representative of the Assistant Commissioner (Technical) will be invited to attend. ☆

New procedural decisions this month

Taxpayer consented to crediting taxes to another. The taxpayer and his brother, as partners, agreed that, in the event of the death of either, the survivor would succeed to the partnership assets and carry on the business. The brother died, and sometime thereafter, additional income was assessed and fraud penalties were asserted against the taxpayer and the estate of the deceased brother based upon the activities of the partnership. The taxpayer overpaid his portion of the tax liability. The overpayment was credited to the liability of the estate of his deceased brother. The taxpayer contended that this transfer and credit to the estate's account was made without his consent. The evidence showed, and this court finds, that the taxpayer did consent to the transfer of the overpayment to the account of the estate. *Murray*, DC Mass., 12/19/60.

Government may serve by publication in order to enforce tax lien. The Government brought suit to enforce assessments against the taxpayer for the years 1943 through 1949. It served the taxpayer by publication, after alleging that the taxpayer's whereabouts were unknown and that he was a fugitive from justice, having been criminally indicted for income tax evasion. Subsequently, the Government alleged that the taxpayer had been apprehended and incarcerated in New Mexico and obtained a court order authorizing personal serv-

ice on him outside of the state of New York. There was some question as to his mental competency, but a New Mexico district court found him to be mentally competent to stand trial for income tax evasion. This court concludes that the taxpayer was mentally competent when the suit was filed because of his criminal conviction and sentencing in New Mexico within a year after service. It further concludes that, barring new evidence to the contrary, taxpayer is mentally competent at the time the default judgment is entered in this proceeding and, therefore, enters judgment enforcing the tax liens against royalties held for taxpayer by a corporation in New York and also against the cash surrender value of a life insurance policy over which the taxpayer had the right to change beneficiary. *Hopkins,* DC N. Y., 12/29/60.

Erroneous refund barred by limitations. After the taxpayer was awarded a judgment of about $5,800, the Government moved to amend the judgment to reduce it by about $870 erroneously refunded interest in 1953 and 1955. Since the motion was in the nature of a suit for recovery of an erroneous refund and as such was barred because it was not begun within two years from the date of refund, this court denies the refund. *Weiler,* DC Pa., 1/6/61.

Deficiency notices deemed proper to give court jurisdiction. Taxpayer filed a joint return with his wife. A deficiency notice was sent by registered mail to taxpayer's lawyer pursuant to a power of attorney, and a separate notice was sent to the wife at their home address. Although both notices were addressed individually, the husband's notice indicated that it was a joint notice. The court holds the method of addressing the notices was not precisely in accordance with the statutory requirement of a joint notice, but nevertheless, it was not "an error or irregularity of sufficient magnitude to nullify the notice," and the court, therefore, had jurisdiction. *Kisting,* TCM 1961-3.

Transferee liability imposed on shareholders of dissolved corporation. A corporation distributed all of its assets in liquidation to taxpayers, its principal shareholders. The Commissioner later determined an income tax deficiency against the corporation and seeks to hold taxpayers as transferees. The Tax Court upholds the transferee liability. The fact that the Commissioner did not first proceed against the corporation and did not send the corporation a notice of deficiency is immaterial. Where, as here, the corporation has dissolved and distributed all its assets, these steps would have been futile. *Kuckenberg,* 35 TC No. 55.

Limitations run from personal service of deficiency notice despite prior mailing. The Tax Court dismissed a petition for redetermination of a deficiency. The taxpayer had filed a petition in the Tax Court within 90 days after personal service of the deficiency notice, but the deficiency notice had been sent to the taxpayer at his correct address by registered mail 28 days before personal service, and more than 90 days before the petition was filed. This court holds that, when the Commissioner chose personal service, he abandoned service by registered mail. The abandonment occurred at the moment of actual personal service. The personal service started a new 90-day period for filing a petition in the Tax Court. *Tenzer,* CA-9, 12/30/60.

No refund after limitations period. Although taxpayer apparently had overpaid its tax, no refund could be made, since suit was not brought within two years of the date the refund claim had been disallowed. The waiver form executed by taxpayer did not create an account stated. *Tolerton & Warfield Co.,* Ct. Cls., 1/18/61.

Net worth computation upheld; omissions fraudulent. In the computation of taxpayer's net income by the net worth method, the Tax Court rejected taxpayer's contention that he had accumulated $35,000 in cash at the beginning of the period. It found the large understatements of income as revealed by the computation, whether due to underreporting of income from disclosed sources or from undisclosed sources or from overstating deductions, could not have been due to inadvertence, carelessness, or ignorance. The Commissioner is held to have met his burden of proof that part of the deficiencies for each of the years was due to fraud with intent to evade tax. This court affirms. *Gatling,* CA-4, 1/6/61.

Interest on interest permitted under 1939 Code. A deficiency against taxpayer was assessed in 1956 for the years 1947-1951, pursuant to an extension of the statute of limitations to which the taxpayer agreed. After the notice and demand, interest was computed from the date of assessment on the entire deficiency, including interest. The court holds that the assessment is governed by the 1939 Code, which permitted interest on interest, even though the assessment is made after enactment of the 1954 Code, which does not permit it. *Ingannamorte,* DC N. J., 12/21/60.

Late payment of estimated tax applied to current quarter first. Taxpayer made no payments of estimated tax during the first two quarters of 1955. On September 15 he estimated his tax at $2,460 and paid three-quarters of it ($1,845). The actual tax for 1955 was $11,497; that for 1954 was $1,817. In computing the 6% penalty for underpayment, the Commissioner took 70% of the actual 1955 tax and treated one-fourth ($2,012) as due each quarter. He applied the September 15 payment against the third-quarter liability and treated the first two quarters as unpaid until April 15, 1956. The court upholds this computation. The calculation must be based on actual liability, not the prior year's tax, even though there would have been no penalty if an estimate in that amount had been filed. *Guglielmetti,* 35 TC No. 72.

Compromise offer not accepted. After the Revenue Agent's examination but before the deficiency notice was issued, taxpayer offered to compromise his tax liabilities for $41,000. He sent a check for that amount with his offer. The deficiency for $80,000 was later assessed and paid. The Government then sent taxpayer a Treasury check for $41,000. The court holds the acceptance of taxpayer's check was not acceptance of the offer in compromise. Since the compromise was not effective, the deficiency was properly assessed. *Moskowitz,* Ct. Cls., 1/18/61.

Procedure when review upsets agreement reached at informal conference. When an agreement reached at an informal conference is upset upon review, the taxpayer will be offered another conference if the decision is adverse to him. If the taxpayer fails to accept the offer and files a protest, the protest will be given to the Conference Coordinator for review. If he thinks the issues could be settled at Audit Division level, he

will schedule another conference for the taxpayer and ask him to attend. *Rev. Proc.* 60-24.

Corporation alive under state law; transferee liability upheld. A corporation under Michigan law continues for special purposes for a three-year period after dissolution. The state law also provides that the dissolved corporation shall continue as a body corporate beyond the three-year period of extended life with respect to any proceeding commenced prior to its dissolution or within such three-year period. The Tax Court held, and this court affirms, that the assessment of deficiencies and the action of the corporation in signing waivers of the statute of limitations and filing an offer in compromise within the three-year period is a proceeding. The corporation, therefore, continued its existence beyond the three-year period. Accordingly, the three-year period did not, as contended by taxpayers, abate or extinguish the extended period of limitations agreed to in the signed waivers. Statutory notices of transferee liability against taxpayers for the corporate deficiencies are held to be timely. *Field,* CA-6, 12/19/60.

No injunction against collection. This court affirms the district court's dismissal of a suit to enjoin assessment and collection. The fact that this might work a hardship on the taxpayer is no grounds for an exception to the statutory rule prohibiting such injunctions. *McDonald,* CA-5, 1/5/61.

Supplemental claim permitted. The original claim for refund filed by taxpayer alleged an overpayment of estimated income tax. A supplemental claim filed after the statute of limitations had run asserted that the assessment was invalid. The court admits the supplemental claim as an amendment. The new theory alleged by taxpayer was within the administrative knowledge of the Government and merely made the allegations more definite and certain. *Caswell,* DC Calif., 11/15/60.

Joint return imposes joint and several liability on wife, even though husband admits full liability. Taxpayer filed a joint return with her husband. After the husband died, taxpayer received a notice of deficiency. In spite of the fact that the husband's estate admitted liability for the full amount of the deficiency and signed a stipulation to that effect, taxpayer is held jointly and severally liable for both the deficiency and the fraud penalties. The court also rules that it retained jurisdiction after the death of taxpayer, even though there was no substitution of parties or representation of her or her estate at the trial. *Diamond Estate,* TCM 1960-264.

Wife liable as transferee. A wife is held liable as transferee of her husband to the extent the husband discharged an encumbrance upon the wife's real estate while he was insolvent. The court finds the transfer was without consideration and was fraudulent under state law. *Cole,* TCM 1960-278.

Form 870 permits assessment without 90-day letter. A waiver Form 870, waiving restrictions against assessment of deficiencies, was signed by taxpayer. The court holds the effect of this form is to waive the right to 90-day notice and permit assessment without such notice. *Kalil,* DC Miss., 10/21/60.

Amended claim did not raise new issues. Taxpayer's original claim for refund was based on the proposition that it was entitled to depletion on reworked minings as well as on newly mined ore. In the course of a Revenue Agent's examination it was discovered that the depletion previously allowed on new ore should be increased because of changes in the gross income computation. Taxpayer amended its claim to include this adjustment at a time when the statute of limitations would otherwise have run. The court finds the amended claim proper. It is still within the original claim for a recomputation of depletion, although on a different theory. *St. Joseph Lead Co.,* DC N. Y., 11/22/60.

Waiver extending limitations effective without Commissioner's signature. Taxpayer signed a waiver extending the statute of limitations. The waiver was not signed by the Commissioner or his delegates during the period for assessment without regard to the extension. Nevertheless, this court holds the waiver was valid. The Government's claim against taxpayer was timely. *Holbrook,* CA-9, 11/30/60.

No injunction against collection of penalty. This suit was brought to enjoin collection of a penalty for failure to pay over withheld taxes. The court dismisses the suit but notes that under *Steele* (280 F.2d 89) the complaint could be amended to a suit for refund if the penalty was paid as to one employee. *Bellah,* DC Ala., 10/24/60.

Complaint must allege timely claim. Since jurisdiction of suits against the Federal Government exists only by statute, the jurisdictional basis must clearly be shown. Affirming the district court, this court holds that a complaint is insufficient when it has failed to allege that the refund claims were filed within the statutory period. *Bell,* CA-6, 12/19/60.

Attorney does not prevail over Federal Government's lien. This case involved the priority of liens between an attorney and the Federal Government. The Government's claim rested upon an assessment made pursuant to Section 6321 of the Code against the taxpayer on May 9, 1958, notice of which was recorded on May 13, 1958. The attorney claimed a "contract lien" against the fund arising out of the oral promise of the taxpayer to pay him $2,500 for legal services in part from this fund. This court holds that the Government prevails. The attorney had no statutory lien because the Texas Statute does not recognize an attorney's lien. Neither did he have a common law or "retaining" lien because that lien is dependent on possession, and the attorney never got possession of the fund, which was held by a stake-holder. He had no charging lien because he recovered no judgment. The court indicates that he might have had an equitable lien if he had "created" the fund, but in this case, the money belonging to the taxpayer was already in the hands of a stake-holder. It was a matter of conjecture whether the attorney "protected" or "saved" the fund for the taxpayer. *Grubert,* DC Tex., 1/5/61.

Federal tax lien invalid for want of demand. Coson brought suit to quiet title to property by virtue of a Federal tax lien for withholding taxes, FICA taxes, and cabaret taxes. He alleged that the Government's claim of lien was invalid for two reasons: (1) He had never been a general partner in the partnership whose operation gave rise to the taxes, and (2) the District Director never demanded that he pay the taxes referred to or any portion thereof. The District Court found for the taxpayer on both grounds and held that the lien

was invalid. This court affirms. The statute provides that the amount of taxes shall be a lien upon the property of a person liable to pay the tax who "neglects or refuses to pay the same after demand." A prerequisite to securing a lien for taxes is demand for payment. *Coson,* CA-9, 1/23/61.

Limitations not applicable to refund claims filed by U.S. for Indians. S.M. 5632 held that the statute of limitations did not apply to claims for refund of taxes paid by an Indian superintendent or other officer of the U. S. on tax-exempt income from restricted Indian lands. The reason for this position was that for the Government to plead the statute of limitations would be contrary to its duty to conserve and guard the assets of the Indians. The IRS now rules that the policy set forth in S.M. 5632 is still being followed. *Rev. Rul.* 61-11.

U. S. cannot levy for husbands' tax upon the rents from property held by entireties. The United States levied upon rents from property owned by a husband and wife as tenants by the entirety with the right of survivorship. The taxes that gave rise to the levy were due solely by the husband. This court holds that under Virginia law the United States cannot levy upon accrued rents derived solely from real estate owned by the husband and wife as tenants by the entirety for taxes due solely from the husband. *Moore,* DC Va., 10/27/60.

Ruling request was not a refund claim. After assessment of a deficiency, taxpayer sent a letter to the Collector of Internal Revenue requesting a ruling that, contrary to the Revenue Agent's determination, the allowance he received for living quarters was not taxable. The court holds this request did not constitute a claim for refund. Since no claim had been filed, the refund was barred by the limitations statute. *Sweeney,* Ct. Cls., 1/18/61.

Negligence is not equivalent to fraud. This court affirms the Tax Court's reconstruction of the net income of a partnership of which taxpayer was a member. The use of the net worth method did not create a duplication of income because of the fiscal year of the partnership. The Tax Court's refusal to assess the fraud penalty is also affirmed. Unquestioned negligence by taxpayer in placing too much confidence in his partner who, admittedly, prepared false returns, which taxpayer signed without examination (having no knowledge of bookkeeping), does not amount to fraud with intent to evade tax. *Burnette,* CA-6, 1/18/61.

New compensation decisions this month

Inventor sells patents and takes job with buyer; part of payment for sale found to be compensation. Taxpayer and his partner were the developers of Univac, the electronic computer. The patents were transferred to a corporation in return for stock. The stock was sold to Remington Rand, and taxpayer took a job with Remington Rand. Payments received by taxpayer from Remington Rand are held to have been made to induce taxpayer to continue in the employment of the corporation rather than as consideration for the sale of the stock. Accordingly, they are held to be compensatory in nature, constituting ordinary income. *Eckert,* TCM 1960-259.

Annuity is forfeitable; employer's contribution is not income to employee. In 1955 a local union, pursuant to its constitution, which authorized it to vote an annuity to any business manager who was forced to retire due to physical condition or age, voted taxpayer, its business manager, a specified annuity for his life or, if he died, an annuity to his wife until his children became 18 years of age. The annuity was to commence at "the time of retirement," which under the international union's constitution would be when taxpayer reached age 65. During 1955, when taxpayer was 61 years old, the union set up a trust to carry out its resolution and contributed $20,000 in 1955, $3,000 in 1956, and $3,000 in 1957; the trust instrument provided that payments to taxpayer were to commence upon written notice by the local. The Commissioner contended that all the amounts contributed by the union were income to the taxpayer in the year contributed, citing Section 402(b), which provides that an employer's contribution to a non-exempt trust is includable in the employee's income if the employee has a non-forfeitable beneficial interest in the contributions at the time the contribution is made. The Tax Court disagrees with the Commissioner, finding that taxpayer's interest was forfeitable, stressing that during the years in question, taxpayer was under 65 and could have had his employment terminated for any number of reasons and that such termination would have ended taxpayer's right to the annuity. *Cappola,* 35 TC No. 48.

Corporation, temporarily transferring employees to its joint venture with others, can treat them as employees for profit plan. Taxpayer is a construction company that engages in joint ventures with others and transfers key employees to the venture for its duration. The IRS rules that, while on the venture payroll, the employees may be considered as employees of the corporation for the purposes, among others, of determining the 15% of compensation limit on contributions, questions of exclusive benefit, etc. The IRS bases its reasoning on the fact that Subchapter K treats a joint venture as a conduit; the members of the venture may treat its income and expenses as if incurred directly by them. *Rev. Rul.* 60-379.

Supplemental payments are income but not wages; employer's accrual discussed. Supplemental employment benefits paid by an employer directly to a former employee under a plan set up by bargaining are income to the employee but are not wages. The employer may deduct the payment when paid or accrued. The payments accrue when liability to a particular employee becomes fixed. No accrual is allowable simply because of the setting aside of funds to meet future obligations. *Rev. Rul.* 60-330.

Payment to widow of corporate officer taxable as compensation. A payment by a corporation of one year's salary to the widow of the former president "as additional compensation and in consideration of services heretofore rendered" by the deceased is held not to have been intended as a gift. The amount in excess of the $5,000 death benefit exclusion is, therefore, taxable to the widow as compensation. *Kuntz Estate,* TCM 1960-247.

*****indicates a case or ruling of unusual importance.***

****indicates a case or ruling having some novelty or unusual interest.***

NEW DEVELOPMENTS IN

Tax-exempt institutions

AND RELATED MATTERS

Annuities offer unique tax advantages to employees of exempt institutions

by **HENRY P. GREEN**

The rules governing the purchase of employees' annuities by exempt institutions are, in many ways, more favorable to the employee than those governing qualified plans. Mr. Green reviews the essentials in qualifying, comments on private rulings that clarify doubtful points, and warns of the necessity for careful planning and sometimes for securing advance rulings to insure that the teachers, doctors, and administrators, the usual beneficiaries, receive all the advantages that are available.

EVER SINCE THE PASSAGE of the Technical Amendments Act of 1958, tax-exempt organizations that can qualify have been able to give their employees substantial annuities for their retirement years, at no additional cost to themselves and, due to the tax advantages, at less cost to the employee than if he purchased his own annuity out of income after taxes. The 1958 Act not only clarified the rules governing these plans but also set rather liberal maximum benefits. In general, these plans can give employees of exempt institutions the benefits available under qualified plans,[1] and in a few very important instances the employees of the exempt institution are treated more liberally. This liberality is in the area of permitting the vesting of title to the annuity contract in the employee himself and the selection of employees to be benefited; the organization can choose to give the plan to just one or more selected employees and not to all, as is ordinarily required in qualified plans.

Eligibility

Congress, in revising the rules, set up conditions. Two, which always must exist, are that the organization be a Section 501(c)(3) organization and that the person for whom the annuity is purchased be an employee. In general[2] we are talking about employees of nonprofit, religious, charitable, educational, literary, and similar organizations. Hospitals[3] are also includable. The great majority of employees we are concerned with are doctors, administrators, teachers, and clergymen.

If the organization has not obtained a ruling that it is a Section 501(c)(3) organization exempt from taxation under Section 501(a) of the Code, application[4] must be made on Form 1023 (Exemption Application) with the District Director of Internal Revenue for the district in which is located the principal place of business or principal office of the organization. The letter reply from the Internal Revenue Service will show whether the organization is exempt from Federal income tax under Section 501(a) as an organization described in Section 501(c)(3).

A question often arises whether a publicly supported school or hospital, such as a state college or county or city hospital, may be held to be a Section 501(c)(3) organization. Many of these organizations are exempt from taxation as being instrumentalities of a state and not because of their charitable or educational nature. In a revenue ruling[5] on a Social Security question, the Internal Revenue Service stated that under certain circumstances such a publicly supported institution may apply for recognition as a Section-501(c)(3) organization. I have seen several unpublished determination letter rulings issued by local District Directors that have not been consistent on whether city, county, or state educational institutions are Section-501(c)(3) organizations. Apparently the Service is aware of these inconsistent positions and for the moment has issued instructions that no determination letters shall be issued until the matter has been resolved. In any event, no harm will result from filing the application now, since the issue will be finally clarified.[5a]

Trade associations, fraternities, labor unions, and similar types of organizations are generally granted tax-exempt status by reason of some subdivision of Section 501 other than Section 501(c)(3). Thus, these organizations will not qualify.

Having established the eligibility of the organization, the tax advantage for the employee can only be obtained through the purchase of an annuity. No life insurance element can be present. Thus, a retirement income plan that contains an insurance element in the earlier years cannot be purchased. Should insurance protection be desired, the employee should acquire it as a separate personal policy. The law clearly calls for a purchase of an annuity by the employer. Therefore, it would appear that some formal step would have to be taken by the employer. This would ordinarily be a resolution adopted by the governing body authorizing the purchase.

Employee status determined

Before the discussion of who is eligible is completed, it is essential that the employee status be clearly established. In most instances there would be no question. Where there is a question, a ruling should be obtained from the Service. Two revenue rulings[6] clearly indicate the criteria usually employed by the Service in determining whether a person is an employee or an independent contractor. Recently two private unpublished letter rulings also indicated three criteria that, it appears, the Government will use in its determination.

[1] Exempt institutions may, if they wish, establish qualified plans.

[2] See proposed Treasury Regulations Section 1.501(c)(3)-1, 1959-2 CB 139, for a full list of organizations that may qualify under Section 501(c)(3).

[3] Criteria for hospital, *Rev. Rul.* 56-185, 1956-1 CB 202.

[4] *Rev. Rul.* 60-143, 1960 IRB 20.

[5] *Rev. Rul.* 55-319, 1955-2 CB 119.

[5a] *Rev. Rul.* 60-384, just issued in IRB 1960-52, sets forth rules under which a state or municipal instrumentality may qualify.

[6] *Rev. Rul.* 57-380 and 381, 1957-2 CB 634, 635.

[*Henry P. Green is associate director and technical adviser of the Division of Special Services of the Agency Department of the Equitable Life Assurance Society. This article is based on a paper Mr. Green presented at the 8th Annual Tax Institute of the University of Montana. The complete proceedings are being published by the University under the title "Estate Planning and Income Taxation," $5 (paper, $3.50).*]

These criteria are (1) the degree to which the individual has become integrated into the operating organization of the employer; (2) the substantial nature, regularity, and continuity of work for the employer; and (3) the authority vested in or reserved by the employer to require compliance with its general policies. Despite the fact that both the hospitals and a radiologist in one instance and a pathologist in the other felt that they were not employees, the Service, in using the above criteria, held that they were employees for withholding tax and Social Security tax purposes. Therefore, it may often be necessary to obtain a ruling as to the employee status to be on the safe side.

Exclusion allowance

With the rules of eligibility established, what is the maximum amount that may be invested in the annuity to be purchased by the employer? Section 403(b) provides that, if an eligible employer purchases an annuity for an employee (but not as part of a qualified pension or profit-sharing plan) and the employee's rights are nonforfeitable, then the contributions to it by the employer are not income of the employee up to the amount of the employee's exclusion allowance.

Section 403(b) defines the exclusion allowance for employer-paid premiums. To the extent the premium does not exceed the exclusion allowance there is no taxable income to the employee until he receives the benefits under the annuity. This exclusion allowance is an amount equal to 20% of his includable compensation for the current year and prior years service. Includable compensation means the gross compensation received by the employee from an eligible employer (other than the amount being paid for the annuity) for the most recent period that constitutes a full year of service. In view of the fact that includable compensation is for the most recent period (ending not later than the close of the taxable year of the employee), compensation of lesser or greater amounts in prior years is to be ignored. The exclusion allowance is reduced by any amount of payments for annuities previously excludable from the gross income of the employee. Although the law in dealing with this reduction for prior payments mentions only annuity contracts, in the absence of regulations it might also include amounts contributed by an employer for the benefit of an employee in a qualified pension plan, even though no annuity contract as such is involved in the plan.

The manner of arriving at the exclusion allowance may be determined by a simple formula:

New employee — .20 (salary) x 1 = exclusion allowance

Old employee — .20 (salary) x years of service — P.E.* = exclusion allowance.

*Payments for annuities previously excludable.

For the purposes of this formula the years of service can never be less than one year. For instance, the exclusion allowance for a new employee under a full-year employment contract at an annual compensation of $10,000 would be $2,000. For an old employee who had nine years of service prior to the current year at the same salary the exclusion allowance would be $20,000. If no previous payments had been made to purchase an annuity for the employee (P.E. in formula), then in the current year the employer could purchase an annuity for the employee without current income tax to the employee by paying a premium equal to the exclusion allowance of $20,000.

Salary reduction formulas

It is doubtful that employers of the type we have described have sufficient surplus money they would be willing to use for the benefit of an old employee. A new employee could negotiate with his prospective employer to set his salary at an amount that, together with the annuity premium, would not be greater than $10,000. In order to treat both new and old employees on an equal footing, the Committee reports[7] clearly indicate that it is the intention to allow an old employee to negotiate to take a salary reduction. In view of the fact that the annuity premium within the exclusion allowance is excludable from the employee's gross income, he is, in fact, obtaining an annuity at a discount equal to the income tax bracket applicable to his income. Stating it another way, the net spendable income is greater if the employer purchases the annuity by a salary reduction than if the employee personally purchases the same annuity.

Formulas for salary reduction in other situations can be easily devised; however, for a new employee, where there is no prior service to be considered, the simplest method of obtaining the exclusion is to take one-sixth of salary. For example, one-sixth of 10,000 = 1,666. New salary $10,000 — 1,666 = 8,334 x 20% = 1,666.

Where consideration of past service is involved, the past service exclusion allowance may be amortized over the remaining period of employment before retirement. The formula for this calculation is similar to the previous one explained, with a few additions. It may be expressed as follows:

.20 (salary — X) x years of service to age 65 — P.E. = years of service remaining to age 65 x X.

X equals salary reduction or maximum annuity premium.

Assume Dr. Jones is employed at a salary of $16,000 a year and that he has 20 years of prior service, with 10 years remaining to age 65. No previous amounts have been used to purchase annuities for him. Thus the salary reduction and the maximum annual amount that might be diverted from salary to purchase an annuity for him would be:

.20 (16,000 — X) 30 = 10X

X = 6,000

Under the above example his salary would be reduced to $10,000 ($16,000 — $6,000). Over the next 10 years $60,000 of his salary would be diverted to purchase an annuity, with no part of such premium being includable in his gross income. In checking to determine if the total amount diverted exceeds the exclusion allowance, we would use the basic formula:

.20 x 10,000 x 30 = $60,000

Thus we know that, if no amount greater than $6,000 a year for the next 10 years is diverted to purchase an annuity, the exclusion allowance would not be exceeded.

Many other formulas can be adopted to determine other amounts. For instance, if Dr. Jones' salary is increased at any time, an additional exclusion allowance would be available. It follows

also that, if his salary were reduced below $10,000 in future years, his total exclusion allowance would likewise be reduced.

The Congressional Committee reports[8] indicate another possibility that may be extremely important to an employee who has many years of past service and only a few years remaining until retirement. It may be possible to divert his entire salary, if he has other sources of income and can afford to take the reduction, to the purchase of an annuity. Since the Commissioner will probably strictly construe these provisions of the Code, caution should be exercised in adopting such a plan in the absence of a specific ruling.

The amount of diverted income can be used by the employer to purchase either single premium or annual premium annuities. Experience indicates that the annual premium annuity is most frequently purchased.

Two recent Tax Court cases, *Zeltzerman* and *Llewellyn*,[9] decided on the law existing before the Technical Amendments Act of 1958, indicate that the Commissioner will insist that there be more than a direction to the employer to deduct the annuity premium from salary. It should first be pointed out that the Commissioner in his Regulations[10] under prior law took the position that the annuity premium must be in addition to or supplementary to current compensation. However, both cases were decided without reference to the Regulations. The facts on *Zeltzerman*, do not indicate any absolute diversion of income. In the *Llewellyn* case formal action was taken to amend the existing employment agreement to provide that the premium payments for the annuity be taken from gross salary. The court held this was, in effect, no different from the doctor taking the income and purchasing his own annuity.

The facts and results in these cases would seem to indicate that there should be a formal amendment in the salary agreement specifically to provide a new salary. To provide for the payment of annuity premiums through a deduction from salary is not sufficient. Those employees operating on a percent-of-gross-income basis would probably have to renegotiate the percentage amount. This formal amendment in the salary arrangement should generally be a separate written agreement and not merely part of any resolution adopted by the governing board for the purchase of an annuity previously referred to.

The plan we have been discussing would appear to be primarily attractive to those in rather high income tax brackets, but we find that many employees who are receiving less than $4,800 from a Section 501(c)(3) employer are also taking advantage of this method of accumulating funds for retirement. Therefore, where a salary reduction is involved, they are concerned with whether their Social Security benefits will be based upon total salary received plus the annuity payment or only upon the reduced salary. The only ruling[11] on this point was issued before 1958, while the Commissioner was taking the position that the annuity premium must be a supplement to salary. He, therefore, held that the annuity premium would be disregarded for Social Security purposes. However, certain local Social Security administrators have orally stated that, where the total salary and annuity premium (where a salary reduction only is involved) do not exceed $4,800, the Social Security tax will be based on both payments. Under these circumstances advisers to the organization should inquire of the local Social Security administrator on what basis the tax should be withheld. If the ruling is favorable to the employee, inquiry should also be made as to the manner of reporting. In that connection a reliable source has advised that the Service has issued a private letter ruling stating that annuity premiums paid by a Section 501(c)(3) employer should not be included on the W-2 form and that the annuity premium should not be considered a part of the employee's compensation for Social Security purposes.

Up to now we have been considering only full-time employees. Part-time employees may also obtain the benefits of the law with minor adjustment. To determine the fraction of his employment, compare the amount of work or number of hours he puts in with the amount of work or number of hours required of a full-time employee doing similar work. If a part-time teacher gives a course at night school six hours a week for one semester and a full-time teacher devotes nine hours a week for two semesters, the part-time employee has completed six-eighteenths, one-third, of a year's service.

As previously stated, under the law the number of years of service shall never be less than one. For example a one-third-time employee at a salary of $4,000 would have the following exclusion allowances:

1st year .20 x 4,000 x 1 = 800
2nd year .20 x 8,000 x 1 − 800 = 800
3rd year .20 x 12,000 x 1 − 1,600 = 800
4th year .20 x 12,000 x 1⅓ − 2,400 = 800

From the above it will be noted that with respect to includable compensation of a part-timer it will be the annual salary that he receives for his part-time work times the denominator of the part-time factor when service for the number of years equal to the denominator has been completed.

As to other formulas for salary reduction involving part-timers, one-sixth reduction of salary for a new employee will be within the exclusion allowance. For an old employee with past service the formula may be expressed as follows: .20 (salary–reduction) times the denominator of the part-time factor times years of service to age 65 over appropriate part-time factor equals number of years remaining to age 65 times reduction, which may be expressed as:

$$.20\ (S\text{-}X)\ N \times \frac{YS}{N} = (YR)\ X$$

[7] Senate Report No. 1983, 85th Congress, 2d Session, page 36, states in part as follows: "The regulations under present law (Section 1.403(a)-1(3)) [the law as it existed prior to the 1958 amendment] provide that an annuity contract purchased by an exempt organization qualifies provided the purchase of the annuity is 'merely a supplement to past or current compensation.' Among the factors mentioned as to whether an annuity contract is a 'supplement to past or current compensation' is whether the annuity contract is purchased as a result of an agreement for a reduction of the employee's salary or whether it is purchased at his request instead of an increase in current compensation to which he otherwise might be entitled. In such cases the regulations state that the amount paid for the contract is to be considered current compensation. Your committee intends the objective 20 percent rule set forth above as a complete substitute for these rules in the regulations. An exception, however, would exist where with respect to an amount already earned an employee took a reduced amount and accepted an annuity instead. In such a case he would have already constructively received the compensation and then converted it into an annuity. Your committee believes that the deletion of these rules in the regulations is particularly important in view of the fact that they favor new employees at the expense of existing employees, who apparently cannot change their terms of employment to conform with those of the new employees."

[8] Report of the Committee on Ways and Means, House of Representatives, states: "Accordingly, an exclusion allowance for the taxable year 1959 may be based upon the includible compensation which the employee received for 1957, if 1957 is the most recent period during which the employee received includible compensation. This type of situation may occur, for example, in a terminal arrangement."

[9] *Zeltzerman*, 34 TC 73, *aff'd per curiam* CA-1, 11/28/60, and *Llewellyn*, TCM 9/2/60.

[10] Regs. Section 1.403(a)-1(a). *Rev. Rul.* 54-267, 1954-2 CB 58.

[11] *Rev. Rul.* 181, 1953-2 CB 111.

For example, assume the above part-timer has been employed for 20 years and has 10 more years remaining until age 65:

$$.20\ (4{,}000 - X)\ 3 \times \frac{30}{3}\ 10X$$

X = 1,500 (salary reduction)

Thus $1,500 of his $4,000 salary could be diverted each year for a total of 10 years or $15,000. His new salary would be $2,500. Checking this to determine whether the "exclusion allowance" is violated, we would use the following formula:

$$.20\ (S \times N)\ \frac{YS}{N} = \text{exclusion allowance}$$

$$.20\ (2{,}500 \times 3)\ \frac{30}{3} = \$15{,}000 \text{ exclusion allowance}$$

As has been mentioned, the amounts paid in annuity premiums by a Section 501(c)(3) organization on the life of an employee within the exclusion allowance results in no taxable income to the employee until he receives payments under the annuity. Under ordinary circumstances there would be no payment by the employee out of his own funds, and thus any payment he receives upon retirement or at any time would be includable in his gross income as ordinary income in the year of receipt. If he receives payments in the form of annuity installments, only the total of the payments received in each calendar year would be subject to income tax as ordinary income.

On the other hand, if the employee also contributed to the annuity purchased or the employer's contributions exceeded the exclusion allowance (such excess would be includable in employee's gross income each year), the usual rules of Section 72 of the Code would be applied to determine the excludable amount of each payment. Sometimes an employee, upon termination of his services by a Section 501(c)(3) employer before retirement, instead of taking a paid-up annuity will decide to continue premium payments from his own funds. In this event the rules under Section 72 would be applicable.

If the employee surrenders the annuity contract for a single-sum amount, it would be taxable as ordinary income to the extent the payment received exceeds the consideration paid by the employee.[12] Likewise, the same tax result would follow if death should occur and payment of a single-sum amount were made to the beneficiary. It seems prudent from a tax viewpoint to use the options for payment of the death benefit and reduce the impact of income taxes in any one year.

As in pension plans, there is a $5,000 exclusion applicable to death benefit payments. However, this special exclusion is only available if the death benefit were received by a beneficiary of an employee of an organization[13] described in Section 503(b)(1), (2), or (3) of the Code. Although every Section 501(c)(3) organization does not fit into the classifications defined in Section 503(b)(1), (2), and (3), the majority will.

Ordinarily the annuity income will be taken by the employee, and gift tax considerations will not be involved. Sometimes he may wish to take income under a joint-and-survivorship-annuity basis. Under the Federal gift tax law[14] favorable gift treatment is provided for the survivorship benefit only to the extent purchased by employer-paid premiums within the exclusion allowance. Again, this favorable treatment is limited to annuities purchased for employees by an organization[15] described in Section 503(b)(1),(2), and (3).

The favorable gift tax treatment does not apply to the value of any benefits payable to the joint annuitant during the employee's lifetime but only with respect to the survivorship benefit. Therefore, to avoid any adverse gift tax treatment, the employee should elect to be the sole payee of any benefits during his life time if a joint and survivor option is chosen.

From the viewpoint of the Federal estate tax the value of such annuities as we have been discussing are excludable from the annuitant-employee's gross estate. This is consistent with the tax treatment afforded qualified pension plan benefits. The exclusion from the gross taxable estate applies only to the extent of the value of the annuity purchased by employer-paid premiums within the exclusion allowance. Congress, as in the case of the death benefit exclusion and the favorable gift tax treatment, limits this exclusion only to annuities purchased for employees by an organization[16] of the type described in 503(b)(1), (2), and (3).

Inasmuch as the plan we have been discussing is attractive from a tax viewpoint for any employee who works for a Section 501(c)(3) organization, it is anticipated that more and more employees will ask their employers for this favorable benefit. In the event a salary reduction is involved, caution dictates that there be a formal amendment of the salary or compensation arrangement to prevent a determination in later years that the annuity premiums were, in effect, paid by the employee and not by the employer. ☆

[12] Temporary Regs. 18.1-5, TD 6335, 1958-2 CB 1112.

[13] The Code makes no provision for capital gains treatment of lump-sum distributions in connection with an annuity not part of a qualified plan. A lump-sum distribution in connection with a qualified annuity, if paid by reason of the employee's death or other separation from service (or death after retirement), will be treated as capital gain if paid within one year.

[14] "In general, these organizations are: 1. Religious organizations. 2. Educational organizations maintaining a faculty and curriculum and having a regularly enrolled body of pupils in attendance at the place where its educational activities are regularly carried on. 3. Charitable organizations receiving a substantial part of their support from a Governmental unit or the general public."

[15] Section 2517, IRC.

[16] See footnote 14, above.

[17] See footnote 14, above.

New decisions

★***Capital gain allowed on sale to charity for percentage of profits.*** Taxpayers sold all the operating assets of their business to a foundation organized by Loyola University of California for $2 million plus the book value of the assets. The foundation paid $100,000 down, and the balance was payable over 10 years, solely out of 90% of the profits it received from the business. After the sale, the foundation leased the property back to a new corporation organized by taxpayer, which operated it for the benefit of the foundation. The court upholds the transaction as a sale resulting in capital gain. There was a bona fide sale in which taxpayer retained only a security interest for payment of the purchase price. In fact, the full price was paid before the end of the 10-year period. *Goldenberg Estate (Union Bank, Ex.)* Ct. Cls., 1/18/61.

Contributions to charitable trust deductible. Income of a trust created "for the use of charitable, educational, scientific, religious, or philanthropic organizations" or organizations contributing materially to the welfare of the citizens of a city is not taxable to the grantor. The Commissioner had objected that a trust for the welfare of the citizens was too broad to be charitable and that no contributions were made

by the unit until a few days before this trial. The court allows the deductions, pointing out that the references to the welfare of the citizens of the city "connote no more than the customary charitable or public purpose." Code Sections 671-678 are not applicable, as the Commissioner contended, because the grantor exercised no administrative powers other than that of a trustee, had no reversionary interest, and had no power to alter or amend the trust. *Miller,* TCM 1960-267.

Old-age-home endowment not charitable. Taxpayer paid a church-operated old peoples' home $7,500 as a room endowment. She was later admitted to the home and, as a room endower, paid $30 a month less than those who were not. At the time of taxpayer's admission, 90% of those admitted were room endowers. Taxpayer claimed a $7,500 charitable deduction. Finding that the payment was in consideration for taxpayer's right to live in the home and at the lower rental, the Tax Court disallows the deduction. In determining that there was no gift, the court cites *Duberstein* (363 U.S. 278), where the Supreme Court set forth various criteria for determining whether the transfer of a Cadillac to a business friend in return for customer referrals was a gift or taxable income. Three dissenting judges would find that there was a charitable gift here on the grounds that the payment did not create a binding contract between the parties and there was a possibility that taxpayer might have been admitted to the home without making the gift. They also dispute reliance by the majority on *Duberstein,* arguing that the rules governing whether the receipt of property is a gift or income are different from those governing charitable contributions. Finally, they point out that many charitable contributions are made with the intent of receiving a benefit and that the Commissioner's review of a donor's motive would undermine Congressional intent to encourage charitable contributions. *O. J. Wardwell Estate,* 35 TC No. 53.

Can deduct gift to college for fraternity housing. A college had adopted the policy of providing proper housing for all students, including fraternity members. A gift to the college to be spent on improvements to be owned by the college is deductible. In the case ruled upon, the college accepts the gifts with the understanding that, although it will use them for the benefit of a particular fraternity, it is not bound to do so. In fact, the leasing of the houses to the fraternities is on a short-term basis, and rentals are fair. *Rev. Rul.* 60-367.

Retail market does not reflect value of charitable contribution. Taxpayer, principal stockholder and officer of several new car dealerships, personally purchased 18 automobiles and donated them to the United Jewish Appeal. The cars were purchased through a special division of General Motors under the specific condition that they be donated and not resold either by taxpayer or his corporations. Taxpayer paid $17,000 for the cars but claims a charitable deduction of $24,000, the retail value of the cars. The Tax Court limited the deduction to $17,000 and this court affirms. The court noted that generally a taxpayer may deduct the fair market value of property contributed to a charity. However, restrictions on marketability must always be considered, and since taxpayer could not resell these cars, the court found that it would be unrealistic to permit a deduction based on retail value. *Cooley,* CA-2, 11/25/60.

State instrumentalities may qualify as exempt institutions. Certain institutions exempt under Section 501(c)(3) (religious, charitable, educational, etc.) may purchase for their employees annuities that enjoy considerable tax advantages. The IRS rules that wholly owned state and municipal instrumentalities that meet the tests in Section 501(c)(3) may obtain exemption and so be able to provide these benefits to employees. The ruling points out that a state or municipality, as such, would not be able to qualify. Thus a school or college that is an integral part of a local government could not meet the tests. However, a separately organized facility, a counterpart of a privately organized one, could qualify. *Rev. Rul.* 60-384.

Contribution to medical foundation created by donor denied. Taxpayer, a vascular surgeon, contributed $7,550 to a medical foundation he and his father helped create. The foundation embarked upon two prime projects, better evaluation of patients with peripheral arterial diseases and a better method of producing vasodilatation in the lower extremities. The work on the prime projects was integrated and grew out of information developed in the treatment of patients who paid fees to the foundation for the services of the laboratory. There was no evidence of how many patients, if any, paid reduced or nominal rates or nothing at all. The court holds that the record does not furnish any basis for holding that the foundation was operated exclusively for scientific or charitable purposes and denies taxpayer a deduction for his contribution. *Cranley, Jr.,* TCM 1961-4.

No deduction for amortization of premium of bonds given to charity. On the authority of *Maysteel Products, Inc.* (33 TC 1021) the court disallows the deduction for amortization of premiums on bonds donated to charity. The differences in facts in this case and *Maysteel* are not sufficient to distinguish them. *Humphreys,* TCM 1961-9.

"Escape" option was extension of lease; exempt organization has unrelated business income. Taxpayer, an organization exempt from income tax, leased its building for a term of 46 months and gave the lessee the right to make improvements. Under a supplemental agreement executed three days after the lease, the lessee could ask for a 59-month renewal at the end of the original lease. If it refused, the taxpayer would be liable to pay the cost of all of the lessee's improvements. The lessee made extensive improvements immediately upon entering the premises. Under the Code, exempt organizations that lease business property for more than five years have unrelated business net income subject to income tax. The Tax Court holds that the supplemental agreement was an option to renew, which must be considered in determining whether the lease was for more than five years. Accordingly, the income from the lease is subject to tax. To hold otherwise would enable taxpayer to offer a long-term lease on better terms than could be offered by a taxable organization, a result Congress sought to prevent. *Chamber of Commerce of Kansas City, Kansas,* 35 TC No. 59.

Contributions to U. S. churches determined under Cohan rule. Deductions claimed by taxpayer for contributions to Catholic churches in the U. S. are determined by application of the *Cohan* rule. But no deduction is allowed for contributions made to churches in France. *Herter,* TCM 1961-19.

NEW DEVELOPMENTS IN

Foreign aspects of taxation

EDITED BY SIDNEY I. ROBERTS, LL.B., CPA, JOHN COSTELLOE, LL.B., AND JOHN WILCOX, LL.B.

MAPI study sees Congress and Treasury tightening up on foreign-source income

THE FATE OF THE Boggs Bill and related legislation in the last session of Congress, the tenor of remarks by committee members and witnesses at Congressional tax policy hearings, recent pronouncements by Treasury officials, litigation seeking to restrict Western Hemisphere Trade Corporations—all these are cited by the Machinery and Allied Products Institute in a recent report[1] to its members as evidencing a crystallization of sentiment unfavorable to the encouragement of private foreign investment by means of tax incentives.

The root cause of the current unfavorable attitude toward tax incentives to foreign investment, is, according to the MAPI study, the rebirth of competition by the industrialized nations of the West with American-made goods and the economic effects of that rebirth. America's continuing unfavorable balance of payments, attributable largely to foreign aid programs, has been accentuated by heavy and continuing private investment abroad. This foreign investment, the study says, has led to charges of the export of jobs and capital, and raised the specter of domestic unemployment. Further, it is said, the imbalance in the balance of payments has resulted in the current outflow of gold and in apprehension over the future of the dollar.

Treasury warnings

Turning to evidences of the current Treasury attitude on WHTCs and foreign base corporations, the MAPI study cited both increased scrutiny of these companies by IRS Agents in the field and remarks by Jay W. Glasmann, former Assistant to the Secretary of the Treasury, at a meeting last year of the Tax Institute. He said:

"Under existing law the reduced rate on Western Hemisphere Trade Corporations and the non-taxable status of foreign corporations have created a tax avoidance situation. Typically, the problem arises because the manufacturing parent in this country sells to its foreign or Western Hemisphere Trade Corporation subsidiary at cost or at a very low margin of profit. If successful, the effect of such a pricing practice is to shift practically all of the profits—both those accruing from the export operation and those attributable to manufacturing—to the selling subsidiary which either pays no United States tax or pays the reduced 38% rate.

"In some cases, taxpayers, by following such pricing policies, have tried to shift all the profits from the combined producing and selling activities to the selling subsidiary even though the 'selling' company has little or no inventory or working capital, few other assets and only a skeleton staff. It may or may not have an office or warehouse abroad. While the Service, under Section 482 of the Code, has broad power to reallocate profits between controlled corporations where there is tax evasion or where it is necessary clearly to reflect income, this provision has always been difficult to administer. This is particularly true where there are no 'arm's-length' transactions to use as a yardstick to measure proper pricing. Unfortunately, some taxpayers in the past, I regret to say apparently upon advice of counsel, have labored under the erroneous impression that the manufacturing parent in this country does not have to make a reasonable manufacturing profit upon goods sold to its exporting subsidiary. I trust that this type of thinking no longer has currency.

"The intercompany pricing problem is not limited to companies manufacturing in this country for sale abroad through controlled subsidiaries. Some companies with manufacturing subsidiaries abroad purchase goods from them for resale in this country. The tendency here is for the United States parent to contend that all or nearly all the profits from the combined production and selling activities should be allocated to the foreign manufacturing corporation if its effective tax rate is below that of the parent. By trying to overdo a good thing, some American businessmen are imposing a serious strain on tax administration and are doing an injustice to the rest of the taxpaying public. If proper restraint in this difficult area is not exercised, the present preferential tax treatment of foreign income may deservedly earn a bad reputation, which could eventually result in legislative action that might go far beyond mere correction of abuse."

Hall decision awaited

MAPI points out that there is currently before the Fifth Circuit a Tax Court case (*Hall*, 32 TC 390) involving the price problem. The Tax Court upheld an IRS allocation of sales profits from foreign operations from a foreign subsidiary (not a WHTC domestic subsidiary) to its parent. The taxpayer controlled a Venezuelan corporation that handled all its foreign sales and shifted income to it by charging it only cost plus 10%, giving a 90% commission for selling and servicing instead of the usual 20% commission he paid for such services. Under the circumstances, the Tax Court sustained the Commissioner in requiring the taxpayer to include in income the full list price of all foreign sales less 20% for selling and servicing.

Source-of-income rules

MAPI points out that many companies studied the use of a WHTC at one time or another or have established one in the past only to discard it later as impractical or burdensome. Many did this after the repeal of the excess profits tax. Other companies have been unable to meet the narrow passage-of-title rule. MAPI calls this the most burdensome of the requirements that must be met to qualify for WHTC status. Under the present Regulations the effective use of a WHTC depends to a large extent on the law of sales. A company must be most careful to see that legal title to merchandise vests beyond the geographical limits of the United States.

Furthermore, the passage-of-title test may present serious commercial problems. Although the U. S. exporter in some cases can arrange his overseas sales in such a way that title is retained until

delivery to the purchaser overseas insures that the substance of a sale occurs outside the United States, other important financial factors may intervene to prevent this.

Boggs bill

The most significant evidence of the current uncertainty about the desirability of tax incentives to foreign investment is the history of H.R. 5, introduced by Representative Boggs and embodying a number of proposals that were advanced in hearings on private foreign investment held in December 1958 by the special House Ways and Means Subcommittee on Foreign Trade Policy. The cornerstone of the Boggs bill, it may be recalled, was the provision that would have allowed the establishment of a special type of domestic corporation called a "foreign business corporation" (FBC), in which foreign source earnings could be accumulated without U. S. taxation until such earnings were repatriated to its U. S. parent corporation.

This tax deferral proposal received wide support from the business community and the endorsement of two special groups appointed by the Departments of State and Commerce—the Straus and Boeschenstein Committees—to advise the Government on ways of stimulating overseas private investment so as to reduce the need for appropriations for foreign aid. The Administration ultimately supported the deferral concept but with rather drastic limitations for export income and a recommendation that deferral privileges be limited to income derived from operations in underdeveloped areas of the world. The Administration based the limitations on its support of the Boggs bill on the rather high level of investment and economic activity at the current time in Western Europe.

Later, there developed great concern in both the Administration and Congress regarding the unfavorable U. S. balance-of-payments position. Very considerable opposition to the Boggs bill manifested itself when the bill was approved by the House Ways and Means Committee in February of 1960. A much-watered-down version of the bill, which included the undeveloped area limitations recommended by the Treasury, was passed by the House of Representatives in May by a vote of 195 to 192. This House-passed version was rejected by the Senate Finance Committee shortly before the adjournment.

In spite of the opposition to and the ultimate defeat of the Boggs bill, one of its provisions—granting taxpayers an option to use the over-all foreign tax credit limitation—was approved.

Another provision of some importance in this area, says the MAPI study, is Public Law 86-779. A domestic corporation may now claim the 85% intercorporate tax credit on dividends received from a foreign corporation paid out of earned surplus previously subjected to U. S. taxation.

A bill, H. R. 11681, that would have decreased from 50% to 20% the ownership requirement in a second-tier foreign subsidiary for the purposes of the foreign tax credit for the American parent corporation, was passed by the House but not acted upon by the Senate.

"Tax sparing" continues to receive attention from both the Administration and Congress. Under the theory of tax sparing, an American taxpayer would be able to claim a foreign tax credit for taxes not paid because they had been temporarily repealed or decreased by an underdeveloped country in an effort to attract foreign investment. Thus the efforts of underdeveloped countries to use the incentive of a tax reduction to increase the level of foreign investment would not be nullified.

Tax sparing was included in the recently negotiated Indian tax convention. Hearings on this convention have been held by the Senate Foreign Relations Committee, but the convention has not yet been approved by the Committee and reported to the Senate. It seems entirely possible, in the light of what happened to the similar tax-sparing provisions in the Pakistan tax convention, that considerable opposition to the similar features of the Indian convention may ultimately manifest itself. It will be recalled that the Pakistan convention was approved, but only after the tax-sparing provision had been withdrawn. In any event, although the Administration apparently continues to regard tax sparing as an important feature in attracting additional American investment to underdeveloped areas, it remains to be seen what the attitude of Congress toward tax sparing will be.

The detailed financial information about newly created foreign subsidiaries required by the new law (P.L. 86-870, discussed in these columns in November, 13JTAX316) will provide the Treasury with a great deal more information regarding the operation of foreign subsidiaries than it has had in the past. What steps, either in the form of administration or legislative recommendations, might ultimately result from the collection, study, and evaluation of such information by the Treasury is far from clear at this time, says the MAPI study. However, it should be noted that there have been indications of concern by top Treasury officials with what they regard as the possibility of abuse in the operation of foreign base corporations or foreign holding companies in tax haven countries.

These tax haven companies are receiving much attention from the Treasury. In the same speech to the Tax Institute that was quoted on the preceding page, Mr. Glasmann went on to say:

"If these American-owned 'tax haven' corporations are to continue to obtain the advantage of deferral of United States tax on their foreign income, legislative changes may be needed: For example, to prevent tax avoidance over and above the already substantial benefits of tax deferral, loans by a foreign-base company to its United States parent might be taxed as a constructive dividend. The same goes for purchases by the foreign corporation of stock or securities in the parent corporation, or in related corporations engaged in business in this country, or the purchase of property to be used by the parent company or a related enterprise. In like fashion, upon dissolution of the foreign-base company, its accumulated earnings might well be taxed at ordinary income rates rather than as capital gain. I believe it is fair to say that the need for such changes to reduce opportunities for tax abuse has already been recognized by the sponsors of H.R. 5."

Need for caution

The MAPI study concludes with this warning:

"In no event . . . should a company interested in foreign operations remain oblivious to [these] developments. . . . Their existence suggests certain obvious implications which every such company should bear in mind. Among them are the following: (1) legislation designed

[1] ***Shifting Trends in Federal Tax Policy Concerning Foreign Source Income: (1) Over-all Review, (2) Western Hemisphere Trade Corporatiins, (3) Current Legislative Developments, (4) Foreign Base Companies.*** **Available for $.50 from Machinery and Allied Products Institute, 1200 18th Street, N.W., Washington 6, D. C.**

to provide direct incentives for private foreign investment is under attack and to be enacted must attract more support than is presently indicated; (2) present law respecting taxation of foreign source income is now under review and will not necessarily remain in effect indefinitely; (3) companies presently employing—or contemplating the use of—either a Western Hemisphere Trade Corporation or a foreign-base corporation would probably be well advised to review present or proposed operating procedures to ensure that such activities in no way constitute 'abuses' as defined or suggested by Treasury authorities." ☆

Treasury report on foreign tax incentives and havens awaited

EVER SINCE the balance of payments crisis began to develop early this year, taxpayers with foreign business interests have been fearful that changes in the tax law dealing with foreign income might be made more with an eye to the economic effect than to equity or the needs of the businesses affected. Furthermore, it early became quite clear that in this technical area there was considerable misunderstanding of the tax law as it now is.

A White House Task Force, headed by Allen Sproul, former president of the Federal Reserve Bank in New York, made a report on Balance of Payments and Domestic Economic Policy. It recommended that the Government "take steps to remove the tax incentives which are promoting private capital investment abroad in the industrially developed countries, many of which, with our help, have regained their economic strength."

This recommendation got considerable notice in the general press, and in the days following, tax lawyers were quoted as pointing out that the provisions in the Code most important in their effect on foreign investment are the long-standing rule that earnings abroad by subsidiaries are not taxed until they are brought home as dividends and the foreign tax credit, adopted to prevent double taxation. Base companies, much mentioned in foreign tax discussions, are generally used to direct the movement of foreign earnings from country to country. Even without the base arrangement, it was pointed out that it was unlikely that earnings would be brought back to the United States so long as there were opportunities for profitable investment abroad.

President Kennedy's State of the Union message referred to the problem again as affected by taxes. He advocated curbs on "tax and customs loopholes that encourage undue spending of private dollars abroad." He said that the Treasury had been directed to submit a report on these problems by April 1.

Political commentators suggested that the new administration would like to get earnings from foreign investments brought home and might be eager to try taxing subsidiaries in the same way as branches. Senator Gore, a member of the Senate Finance Committee, introduced a bill that would tax the earnings of foreign subsidiaries in the year earned and repeal the foreign tax credit and the special tax reduction for Western Hemisphere Trade Corporations. He said that his motive was to slow down the flow of new funds abroad. ☆

Congressional tax committees' new members appointed

THE APPOINTMENT OF Senator Fulbright (D-Ark.) to the only vacancy on the Finance Committee disappointed liberals but pleased the gas and oil industry.

Although he has voted as a liberal in some areas of social welfare and civil liberties, he is expected to vote conservatively during the next two years to improve his chances for re-election in 1962. Political expediency also explains Senator Fulbright's leaving an influential spot on the Banking Committee, for among other matters it considers housing legislation. A Southern Senator might find it embarrassing, if not impossible, to support both President Kennedy's integration program and his constituents.

In the House of Representatives, all holdovers from the 86th Congress were reappointed to the Ways and Means Committee. The Democrats had two vacancies to fill and elected Rep. Al Ullman (Ore.), a real estate man active in resource development, and Rep. James A. Burke (Mass.). The Republicans have appointed Rep. Steven B. Derounian of New York. ☆

New decisions affecting special industries

Conveyance of license to cut timber not entitled to capital gain treatment. The taxpayers were partners in a partnership engaged in the business of logging, sawing, and manufacturing lumber. Three of the partners organized a corporation and, pursuant to an oral arrangement between the partnership and the corporation, permitted the corporation to cut and remove the timber. The partnership contended for capital gains treatment on the payments received by the partnership from the corporation on the amount of timber cut and removed. The Tax Court found that the partnership had no title to the timber it could convey to the corporation, and hence, the partnership could not have held the timber it sold, as it was cut and manufactured, for more than six months before the sale. Secondly, the Tax Court found that the partnership and the corporation entered into "a loose, oral arrangement" terminable at the will of either party, which did not constitute a binding contract. Thirdly, the Tax Court found that, after the partnership sold its equipment to the corporation, the partners had no trade or business other than selling timber. This court agrees with the Tax Court that the partnership was not the owner of the timber within the meaning of Section 117(k)(2) of the 1939 Code (now Section 631(b) of the 1954 Code) and that the oral agreement between the corporation and the partnership was in the nature of a continuing offer to sell, rather than an actual disposal. Under this interpretation, there was no holding of a capital asset by taxpayers for more than six months.

As to the sale of other timber, this court agrees with the Tax Court that, after the partnership sold everything it used to cut and manufacture timber, it had no trade or business other than selling timber and, accordingly, the sale of the timber on the other tract was the sale of "property held by the taxpayers primarily for sale to customers in the ordinary course of its trade or business." *Jantzer*, CA-9, 9/11/60.

TAX PRACTITIONERS'

Shop talk

EDITED BY THEODORE BERGER, LL.B., CPA, & BURTON W. KANTER, J.D.

This is an informal exchange of ideas, questions, and comments arising in everyday tax practice. Readers are invited to write to the editors: Theodore Berger and Burton W. Kanter, 209 South LaSalle Street, Chicago 4, Illinois.

Taxpayer challenges use of gift tax valuation table

UNDER Regs. Section 25.2512-5(a)(1), the transfer of property in which an interest is retained requires the valuation of the gift. The gift is equal to the total fair market value of the property transferred, less the value of the donor's retained interest, whether that be a reversionary interest or a life estate. These interests are determined under the valuation tables provided by the Treasury computed on the basis of a 3.5% rate of interest compounded annually.

In the case of *John N. Lisle,* Tax Court Docket No. 88068, the taxpayer retained a life estate in real estate and made a gift of the remainder interest. The taxpayer is contending that the computation of the value of the gift of the remainder interest in real property should be based on the amount of net income actually to be received from the property, rather than the 3.5% rate used in the Treasury tables. In this case, taxpayer's property was under lease for a term of 10 years from October 1, 1955, on a net lease basis. In 1956, taxpayer deeded the real estate to his children, retaining a life estate with respect to the total net income.

Assume taxpayer had a life expectancy of eight years, that the net lease rental is $6,000 a year, and that the total fair market value of the property on the date of transfer was $125,000. The taxpayer would value the remainder interest transferred by gift as follows:

Value of entire property	$125,000
Less value of right to receive $6,000 annual income for eight years ($6,000 x 6.8740)	41,244
Value of gift of remainder ...	$ 83,756

Note that the taxpayer in effect would consider the actual income as an annuity and value the gift as the value of the entire property less the value of the annuity. The Treasury, on the other hand, would apply the table in Regs. Section 25.2512-5 directly and value the remainder at $94,926 ($125,000 x .759412).

This may well be a case of first impression, where an actual challenge is made to the Treasury form of computation. It is obvious that, where the income yield is in excess of 3.5% and the gift is the gift of a remainder interest, the amount of gift tax to be paid will be less if the life estate retained is valued on the basis of a higher actual income yield. The situation is reversed, however, if the gift is in the form of a short-term reversionary trust, where the gift is a gift of income for the period. In such a case, if the actual income yield were in excess of the 3.5% utilized by the table, taxpayer certainly would not be arguing for computation of the gift based on the actual income yield.

Perhaps it is the fact that the Government and the taxpayer may each be arguing opposite sides when it best suits their interests that justifies adoption of the general rule required by the Regulations. ☆

Subchapter-S shareholder is not both old and new

THE NECESSITY of a shareholder in a Subchapter S corporation who has already consented to the election to consent once again upon acquiring additional shares in the company was raised in our November column. Erwin G. Schreiber, a Seattle CPA, has written to us about this point.

"If the interpretation in your column were correct, then any shift of shares between two shareholders would be an easy way to automatically end an election by the new shareholder's refusal to file consent.

"But, I do not think that the Service's interpretation mentioned in your column is correct.

"According to the dictionary a shareholder is one who has a share in a stock company or other association; and his being a shareholder is independent of the number of shares he owns, as long as he owns at least one share.

"I think the regulations bear this out, though in a negative way. Reg. 1.1375-4(e) states: 'If a shareholder transfers part but not all of his stock in an electing small business corporation, his net share of previously taxed income is not reduced by reason of transfer. . . .'

"The purpose of the consent requirement is to assure that the shareholders only by their free will accept the special provisions of Subchapter S, mainly the liability to pay the income taxes which otherwise the corporation would have to pay. An old shareholder has already declared his consent, and since he has the right to withdraw such consent, there is no valid reason why he should again give his consent." ☆

CLASSIFIED ADVERTISING

Classified advertising will be accepted for publication for help wanted, situations wanted, business opportunities, practices for purchase or sale, purchase and sale of merchandise, and similar items. Rate per insertion: 60¢ per line, minimum, $3. Address copy for advertisement, together with check, to The Journal of Taxation, 147 East 50th Street, New York 22. Replies should also be sent to this address.

TAX ATTORNEY, Phi Beta Kappa, Coif, Law Review, 4 years in Chief Counsel's Office IRS, seeks position with corporation or law firm. Resume upon request. Box 529.

BINDERS

are available for THE JOURNAL OF TAXATION. Each binder will hold 12 issues of the magazine (2 volumes), running from July to June. When ordering, please specify the volumes you want the binder for. Price: $3 for each binder. Order from:

THE JOURNAL OF TAXATION,
147 East 50th Street, New York 22.

CUMULATIVE INDEX

This index includes material published in The Journal of Taxation in recent months, plus major books and pamphlets currently useful. Average length of cumulation of listing is six months, though older items will be retained if they are the most recent significant discussion of that subject.

ACCOUNTING—BOOKS

Oehler C, *Lawyers Accounting Handbook*, Matthew Bender & Co., (New York) 1 vol., $15.

Peel Jr., Fred W, *Consolidated Tax Returns*, Callaghan & Co. (Chicago, 1959) $20.

Wriggins J C & G B Gordon, *Repairs vs. Capital Expenditures*, Ronald Press Co. $10.00. Tax practitioners featuring tables of cases, showing taxpayer's arguments and court's findings

ACCOUNTING—ARTICLES

Amortization of leasehold costs, proposed regulations criticized, 13JTAX 362, Dec60.

Appreciated property, some uses of, bring realization of gain and tax, 14JTAX77, Feb61.

Consolidated returns, cryptic ruling on, attempts to block tax avoidance, *Leon Hariton*, 13JTAX262, Nov60.

Covenant not to compete, tax on, will be fixed if business sale is well planned, *Richard J. Barnet*, 13JTAX 358, Dec60.

Depreciation changes, ABA Tax Section rejects most proposed, 13JTAX232, Oct60

Equipment lessees can schedule payments, and deductions, to avoid tax hazards, *Frank K. Griesinger*, 13JTAX226, Oct60

Installment status of sale, payments by buyers on assumed mortgages can endanger, *Robert D. Miller*, 13JTAX231, Oct60

Intercompany distributions, Code and consolidated Regulations conflict on basis after, *Leon Hariton*, 14JTAX74, Feb61.

Interest, is it deductible only if the debt has a nontax profit purpose? *William H. Harrar*, 13JTAX258, Nov 60.

Inventory contributions, valuing at market for tax benefit opposed by Kefauver, 14JTAX78, Feb61.

Leased property, new Regulations clarify loss on demolition of, *William L. Raby*, 13JTAX227, Oct60.

LIFO inventories involuntarily liquidated, Tax Section recommends relief for, 13JTAX232, Oct60.

LIFO Regs. please accountants, dollar-value, 14JTAX163, Mar61.

Loan has real business purpose, Knetsch means interest is allowable only if, *I. Jerome O'Connor*, 14JTAX160, Mar61.

Loans, Supreme Court, deciding Knetsch narrowly, leaves question of 3-way loans unanswered, 14JTAX5, Jan61.

Municipals, is the tax exemption threatened? 13JTAX361, Dec60.

Natural gas tax benefits cut costs for rate purposes, 13JTAX268, Nov60.

Net lease income is taxable as unrelated business income, 13JTAX229, Oct60

Overhead expenses, many can be cut from inventory for tax purposes, *Albert J. Bows*, 14JTAX164, Mar61.

Prepaid income, Streight and Schlude fail to follow Bressner analysis of, *John M. Sullivan*, 14JTAX2, Jan.61.

Property tax, Code now denies double deduction for; other new provisions in new laws, 13JTAX266, Nov60.

Revolving credit account, when is it an installment account for taxes? *Joseph M. Mero*, 13JTAX361, Dec60.

Stock warrants, package deal is best for lender taking, to sweeten a loan, *Malcolm E. Osborn*, 13JTAX354, Dec 60.

Sublet leasehold, sale of, is capital gain; Tax Court reversed, *Comment by Raymond Rubin*, 13JTAX267, Nov60.

Tax v. business accounting, CA-2, deferring accrual despite payment, splits on, 13JTAX230, Oct60

COMPENSATION—BOOKS

Gordon G B, *Profit Sharing in Business and Estate Planning*. A study of profit-sharing from the viewpoint of employer and employee, covering benefits, kinds of plans, financial, legal and tax problems. Farnsworth Publishing Co., Inc. $3.50.

Rice L L, *Basic Pension and Profit-Sharing Plans*, Committee on Continuing Legal Education (Philadelphia, 1957) 148pp, $3.00

COMPENSATION—ARTICLES

Commissions on sales to himself, cases taxing an employee on, threaten other fringes, *by James S. Eustice*, 13 JTAX322, Dec60.

Congressional tax committees, election put 4 new men on, 14JTAX26, Jan61.

Employee thrift plans: a popular extra in the profit-sharing package, *Isidore Goodman*, 14JTAX20, Jan61.

Options outside 421, Regs. on, apply to employees only, 13JTAX293, Nov60.

Pension and profit plans, strict rules limit investments of qualified, *Isidore Goodman*, 14JTAX153, Mar61.

Pensions costs, slow vesting can cut, but IRS opposes it for small firms, *Harold W. Chatterton*, 13JTAX218, Oct.60.

Stock option plans, SEC division report scores, 13JTAX293, Nov60.

Stock options for other than employees, IRS withdraws proposals on, 14JTAX 159, Mar61.

CORPORATIONS—ARTICLES

Accumulated earnings cases, Tax Court may be confused on burden of proof in, *John E. Scheifly*, 14JTAX141, Mar61.

Business purpose, must corporation have? 13JTAX347, Dec60.

Capital gain allowed in partial liquidation, 13JTAX245, Oct60.

Collapsibility, post-construction decision to sell avoids, CA-3 says, *James T. Wilkes, Jr.*, 13JTAX244, Oct60.

Exchanges with foreign corporations, how the IRS regards: Section 367 rulings, *by Frances B. Rapp*, 13 JTAX344, Dec60.

Family and estate attribution made in first 1954-Code dividend equivalence case, *Norman Sinrich*, 14JTAX136, Mar61.

Liquidations, Tax Court in LaCrescenta takes a sensible approach to 337, *Michael L. Weisman*, 14JTAX138, Mar61.

Loss carryovers, proposed 382 Regulations take some doubtful positions on, *Paul A. Teschner*, 14JTAX130, Mar61.

Multiple corporations, IRS finds support in courts for attacks on, 13 JTAX297, Nov60.

Pelton decision, CA-1 "expressly disapproves" Tax Court's, *Comment by John L. Palmer*, 13JTAX301, Nov60.

Rights to income are distributed in liquidation, tax planning is vital when, *John P. Miller*, 13JTAX194, Nov60.

Small Business Investment Company, how tax advantages are obtained from a, *Richard K. Sell & Robert J. Kalupa*, 14JTAX66, Feb61.

Stock dividend issue expenses are not deductible, IRS wrong in ruling that, *Gerald J. Kahn*, 13JTAX246, Oct.60.

Stock redemption, CA-4 rejects Section 102: Pelton Steel collapsed, *Richard L. Greene*, 14JTAX68, Feb61.

Stock-redemption plans, tax traps for company and owner lie hidden in many, *Richard L. Greene*, 14JTAX12, Jan61.

Unsettled claims in tax-free merger, Carlberg shows possible way to allow for, *by David R. Tillinghast*, 13JTAX 348, Dec60.

ESTATES, TRUSTS & GIFTS—BOOKS

Beveridge J W, *Beveridge Law of Federal Estate and Gift Taxation*, Callaghan & Co., (Chicago, 1956-58) 1544pp, $60.00

Kennedy L W, *Federal Income Taxation of Trusts and Estates*, Little, Brown & Co., (Boston, 1948) with 1953 supplement. 837pp. $20.00. This is the text on the subject; thorough, comprehensive.

Lasser Institute J K, *How to Save Estate and Gift Taxes*, American Research Council, Inc., $5.95.

Lasser Institute J K, *53 New Plans For Saving Estate and Gift Taxes*, American Research Council, Inc. (Larchmont, N. Y.) $5.95.

Lasser Institute J K, *Estate Tax Techniques*, Matthew Bender & Co., (New York) 1 vol., supplemented, (loose-leaf) $27.50. Written by 46 authors.

Lowndes & Kramer, *Federal Estate and Gift Taxes*, Prentice-Hall, (Englewood Cliffs)

Michaelson A M, *Income Taxation of Estates and Trusts*, Practicing Law Institute (New York, 1959) 86pp, $2

Nossaman W L, *Trust Administration and Taxation*, Matthew Bender & Co. (New York) 2 vols., (loose-leaf) $42.50.

Olson R L & Gradishar R L, *Saving Income Taxes by Short Term Trusts*, Prentice-Hall, (Englewood Cliffs, 1956) 203pp, $7.50. Exposition of Code; examples.

Trachtman J, *Estate Planning*, Practicing Law Institute (New York, 1959) 178pp, $2.50

Spinney R, *Estate Planning, Quick Reference Outline, 6th Edition, 1959*, Commerce Clearing House, $1.50, 96pp

Wormser R A, *Wormser's Guide to Estate Planning*, Prentice-Hall Inc., (Englewood Cliffs, N.J., 1958) 167pp, $4.95. Written for the client.

ESTATES, TRUSTS & GIFTS—ARTICLES

Cross-purchase plan, advantages of, over redemption in certain situations, *Addis E. Hull III*, 14JTAX84, Feb61.

Family allowances and renunciations, careful handling of, can save taxes, *Harlan F. Harmsen*, 14JTAX50, Jan 61.

Foreign-situs trusts, IRS clarifies, as bill to end some tax benefits dies, *Alan H. Hammerman*, 13JTAX199, Oct60.

Lifetime gifts offer larger tax savings than charitable bequests of art works, *David P. Wood, Jr.*, 13JTAX202, Oct 60.

Marital-deduction property can kill estate and income deductions, *Richard G. Hewitt*, 13JTAX285, Nov60.

Marital deduction, utmost care is needed in qualifying insurance for the, *C. Ives Waldo, Jr.*, 13JTAX280, Nov60.

Minor's rights, Tax Court's Briggs comment on, raises support trust problems, *Charles A. Lippitz*, 14JTAX 90, Feb61.

PLI's estate tax manual new edition is out, 14JTAX178, Mar61.

Stock-purchase agreements, tax planning to avoid the dividend hazard in, *Addis E. Hull III*, 13JTAX337, Dec60.

U. S. possessions, estate and gift tax statutes modified for, 14JTAX178, Mar61.

Wills drafted for administrative flexibility bring income tax savings, *William K. Stevens*, 14JTAX172, Mar61.

EXCISE—ARTICLES

Cabaret tax, liability for, depends on time of service and collection, *Burton L. Graubart*. 13JTAX223, Oct60.

EXEMPT ORGANIZATIONS—BOOKS

Webster G D, *Federal Tax Aspects of Association Activities*, 114pp, $4.50, Current tax situation; the Code and Regulations and how they are applied

EXEMPT ORGANIZATIONS—ARTICLES

Riding club, exemption of, on Tax Court Docket, 14JTAX121, Feb61.

Social clubs, ruling threatens loss of exemption to, when non-members use facilities, *Peter Elder*, 14JTAX120, Feb61.

FARMERS—BOOKS

Halstead H M, *Federal Income Taxation of Farmers*, Committee on Continuing Legal Education, (Philadelphia, 1956) 129pp, $3.00

FOREIGN—BOOKS

Diamond W H, *Foreign Tax and Trade Briefs*, Matthew Bender & Co., (New York) 1 vol., (loose-leaf) $50, includes service for one year. The tax structure of 71 countries.

Foreign Investment and Taxation, International Program in Taxation, Harvard University, (Cambridge), $7.50.

Friedmann W G & Pugh R C, *Legal Aspects of Foreign Investment*, taxes on profits and dividends, Little, Brown & Co. 812pp, $20.00.

International Tax Agreements, Vol. VII. Columbia University Press, (New York, 1958) 384pp, $2.50, Classified

Tax Factors in Basing International Business Abroad, International Program in Taxation, Harvard University (Cambridge), $5.00

FOREIGN—ARTICLES

Australia withholds tax on nonresidents' dividends, 14JTAX185, Mar61.

Canada and U. S. both raise withholding on dividends, 14JTAX1894, Mar61.

Citizens abroad, new guide is published, 14JTAX185, Mar61.

Cuban assets seized, when is loss deductible? 14JTAX184, Mar61.

Malta offers tax holiday to new firms, 14JTAX185, Mar61.

"Real property," double estate tax possible with unclear, 13JTAX251, Oct60.

Regulations, final for foreign subsidiaries eliminate many objectionable features, *Paul D. Seghers*, 14JTAX48, Jan61.

Royalties bring profits of foreign subsidiaries home at low tax cost, *Monroe Adlman*, 14JTAX45, Jan61.

Salary exempted from U. S. tax, Tax Court allows credit though sole foreign income was, *Henry H. Steiner*, 14JTAX183, Mar61.

Stocks, tax laws discourage American purchase of foreign, 13JTAX380, Dec60.

Subsidiary, shareholders must now report creation of foreign, *Comment by Martin Lore*, 13JTAX316, Nov60.

Swedish corporate taxes explained in pamphlet, 14JTAX185, Mar61.

Title-passage method outside U. S. as means of tax saving approved in two new decisions, *Paul D. Seghers*, 14 JTAX95, Feb61.

U. S. employees of foreign governments covered by OASI, 14JTAX184, Mar61.

FRAUD—BOOKS

Balter, *Fraud Under Federal Tax Law*, Second Edition, 1953, Commerce Clearing House, $7.50, 495pp

Balter, H G, *Tax Fraud: What the Practitioner Needs to Know to Protect His Client*, The Journal of Taxation, (New York, 1957) 96pp, $2.00. Articles originally published in *The Journal of Taxation*, *"Practitioners' Guide No. 3."*

FRAUD—ARTICLES

Deductibility of the "necessary" expense incurred in tax fraud, guides for, *Harry Graham Balter*, 13JTAX306, Nov60.

Evasion, conference misstatement by unwary taxpayer may extend time on, 13 JTAX304, Nov60.

Immunity for voluntary disclosure should be in Code, ABA Section says, 13 JTAX252, Oct60.

INSURANCE—ARTICLES

Regulations, new, on insurance companies take doubtful positions, *Stanley C. Simon*, 14JTAX114, Feb61.

INVENTORY—BOOKS

Butters J K, *Effects of Taxation; Inventory Accounting and Policies*, Harvard (Cambridge, 1949), 330pp

OIL, GAS AND MINERALS— BOOKS

Breeding & Burton, *Taxation of Oil and Gas Income*, Prentice-Hall, (Englewood Cliffs).

Fiske, L E, *Federal Taxation of Oil and Gas Transactions*, Matthew Bender & Co., $25.00

PARTNERSHIPS—BOOKS

Aronsohn A J B, *Partnerships*, Practicing Law Institute, (New York, Revised to October 1958) 108pp, $2.00.

Willis, *Handbook of Partnership Taxation*, Prentice-Hall, (Englewood Cliffs, 1957) 585pp, $15.00. The author was chairman of the advisory group on Subchapter K (partnerships) appointed by the House Ways and Means Subcommittee on Internal Revenue Taxation

PARTNERSHIPS—ARTICLES

Firm's installment notes at gift of his interest, error seen in taxing partner on, *Alan R. Bromberg*, 14JTAX36, Jan61.

Good will of a professional is salable, IRS and recent cases recognize that, *W. Fletcher Hock*, 14JTAX34, Jan61.

Kintner Regulations, final, adhere to state law test, 14JTAX37, Jan61.

Kintner rules, qualifying under final, will be difficult in most states, *Bernard Wolfman & Joheph W. Price, 3rd*, 14 JTAX105, Feb61.

PAYROLL—ARTICLES

Federal U.I. tax increased from .37% to .4%; other changes in the law, 14-JTAX60, Jan61.

Self-employment over 45 hours will

mean a cut in Social Security benefits, 14JTAX127, Feb61.
Social Security, parents working for children come under; other changes in law, 13JTAX378, Dec60.

PERSONAL—ARTICLES

Candidate's campaign expenses, Tax Court, in denying, leaves door open, 13JTAX276, Nov60.
Costs of benefiting others, even of buying assets, are sometimes deductible, 13JTAX332, Dec60.
Expense accounts, what the employer must report about, on 1960 returns, *Charles M. Walker*, 14JTAX98, Feb 61.
Faculty meals, new rule extends convenience-of-employer exclusion, *Alan Prigal*, 14JTAX149, Mar61.
Fellowship income rule, IRS' use of gift-v.-compensation test delays practical, *Donald H. Gordon*, 13JTAX272, Nov60.
Gift in payment to executive's widow, Tax Court, applying Duberstein, sees no, *Ernest Getz*, 14JTAX27, Jan61.
Marital settlement, CA-6 finds income in, but says valuation difficulty bars tax, *Allan R. Curhan*, 14JTAX30, Jan61.
Medical deductions, take with care if over 65, 14JTAX150, Mar61.
Minimum deposit and bank loan life insurance, new attack on, *Stanley C. Simon*, 13JTAX211, Oct60.
New law: Fewer estimates and more deductions, 13JTAX278, Nov60.
Philanthropists, who are they? 14JTAX 150, Mar61.
Pomona plans, IRS revocation of approval of tax-exempt, raises collateral questions, *William C. Penick*, 14JTAX 102, Feb61.
Ponies, IRS out-runs, 13JTAX334, Dec 60.
Social Security benefits, AFL-CIO group suggests tax on, 14JTAX150, Mar61.
Studebaker's rebate to stockholders buying a 1960 Lark is not a dividend. 13JTAX275, Nov60.
Support, what is? If others provide it, claiming dependent is dangerous, 13 JTAX209, Oct60.
T&E audits are getting rougher; taxpayers' best defense is complete substantiation, *Edward J. McGowen*, 14 JTAX146, Mar61.
Workers' travel, tax on, still not settled; new Rev. Rul. not final answer, *L. Charles Johnson*, 13JTAX206, Oct60.

POLICY—ARTICLES

Deduction for taxpayer who has no available loopholes isn't such a bad idea, 13JTAX314, Nov60.
Depreciation, is the present policy encouraging the growth of slums? 13 JTAX313, Nov60.
Duberstein, Griswold sees, as example of excessive reliance on fact finders, 14JTAX118, Feb61.

PRACTICE—ARTICLES

CPA, as tax advisor, weighs IRS position, case law, and client need, *Horace J. Littlefield*, 14JTAX54, Jan61.

PROCEDURE—BOOKS

Goodrich E J & Redman L, *Procedure Before the Internal Revenue Service*, Committee on Continuing Legal Education, (Philadelphia, 1957) 205pp, $3.00
Lore M M, *How To Win A Tax Case*, Prentice-Hall, (Englewood Cliffs)
Roberts et. al., Handbook of Annoted Forms for Tax Practice, Prentice Hall, Inc., Englewood Cliffs, N. J., $24.75

PROCEDURE—ARTICLES

Automatic Data Processing program starts in 1961, 13JTAX291, Nov60.
Electronic system, IRS starts, and gets new personnel, 13JTAX241, Oct60.
Independent conferee may make appeal worthwhile, 13JTAX241, Oct60.
IRS Washington office gives advice only; regional offices settle cases, 13 JTAX 290, Nov60.
Justice Department claims speed and efficiency in '60, 14JTAX44, Jan61.
Late-filing penalties, 90-day letter not needed for, 13JTAX290, Nov60.
Offers in Compromise: practical points on how to go through the wringer safely, 14JTAX42, Jan61.
Private meter, date shown by, is not proof of timely filing of tax return, 14JTAX82, Feb61.
"Quota system" for Agents, Commissioner again attacks, 14JTAX82, Feb 61.
Recruiting and training, IRS trying to improve, 14JTAX182, Mar61.
Regional Counsel, IRS enlarges role of, 13JTAX291, Nov60.
Returns, IRS auditing more, 13JTAX-292, Nov60.
Rulings and technical advice, when and how should the practitioner ask for? *Paul D. Yager*, 14JTAX38, Jan61.
Tax Court cases, IRS presses for disposition before trial, 14JTAX180, Mar61.
Tax Court decisions, detailed rule proposed for review of, 14JTAX181, Mar 61.
When to disagree with the IRS: How a practical taxman plans his strategy, *Roger L. Davis*, 13JTAX374, Dec60.
Withheld taxes, consequences of withholding from the Government, 13 JTAX288, Nov60.

REAL ESTATE—ARTICLES

Real estate investment trust, Congress approves; exacting rules made, *Sidney I. Roberts, Arthur A. Feder*, and *Herbert H. Alpert*, 13JTAX194, Oct 60.
Real estate investment trusts, sessions being held, 14JTAX188, Mar61.
Undue thinness, protecting the real estate corporation against a charge of *Stanley P. Wagman*, 14JTAX186, Mar61.

SHOP TALK—ARTICLES

Basis of several items in gift, how to add tax to, 14JTAX125, Feb61.
Collapsible corporation, is Section 302 applicable to a, 14JTAX189, Mar61.
Group life policy, assignment raises tax issues, 14JTAX189, Mar61.
Jensen option sale was really sale of shares, 14JTAX62, Jan61.
Land exchanges, Commissioner attacks, as being really sales, 14JTAX126, Feb61.
Liquidation taxable if 25% of stockholders own successor? 14JTAX62, Jan61.
Livingstone example corrected, 14JTAX 63, Jan61.
Mutual takes over investments, adjustments required, 14JTAX190, Mar61.
Partnership distribution, 754 election can prevent tax on, 14JTAX124, Feb 61.
Partnership proposal to bar tax-free exchange queried, 14JTAX189, Mar61.
Pomona plan, General Shoe case may affect, 14JTAX62, Jan61.
Return of "Income is where you find it," 14JTAX124, Feb61.
Section 367, spotlight on shows unusual features, 14JTAX190, Mar61.
Short-sale payments, IRS issues new ruling on, 14JTAX62, Jan61.
Surtax exemption should be allowed to multiples in full, 14JTAX124, Feb61.
Sweepstake ticket, assignment challenged, 14JTAX125, Feb61.
University of Chicago Tax Conference panel, 14JTAX126, Feb61.
Will or partnership agreement: which controls? 14JTAX63, Jan61.

STATE AND LOCAL TAXES—ARTICLES

Alabama tries psychology, 14JTAX122, Feb61.
Auditor's task under new state tax rules is difficult, but much help to client, *Oliver O. Cromwell*, 13JTAX308, Nov 60.
City income tax, should the U. S. withhold? 14JTAX58, Jan61.
Connecticut tax handbook is published, 14JTAX59, Jan61.
Federal law limiting state tax on interstate firms, Dane asks "exempt unless," 13JTAX369, Dec60.
Federal tax laws, state officers ask changes in, 14JTAX59, Jan61.
Georgia switches sales tax from vendor to consumer, 14JTAX58, Jan61.
Interstate business, NTA group asks Federal law on tax on, 14JTAX58, Jan61.
New Jersey resolves its assessment problem, 14JTAX58, Jan61.
New York puts 15-year limit on all estate tax liens, 14JTAX122, Feb61.
New York taxes free-lance artists as businessmen, 14JTAX122, Feb61.
Non-residents, new case makes tax collection from, easy, officials warn, 13 JTAX215, Oct60.
Property tax, why is it in general disrepute? 13JTAX310, Nov60.
Suburban farm lands, do they merit rural tax rates? 14JTAX122, Feb61.
Supreme Court docket, a number of important state tax issues are currently on, 13JTAX370, Dec60.
U. S. tax records, all states use some in enforcement, 14JTAX59, Jan61.
Wisconsin property taxes can't go much higher, 14JTAX122, Feb61.

TAX PRACTICE—BOOKS

Boughner J L, *Tax Planning & Fee Setting for Profitable Law Practice*, The Journal of Taxation, (New York, 1958) 110pp, $8.00. Looseleaf, includes periodic revisions.

AUTHORS

45 Monroe Adlman
306 Harry Graham Balter
358 Richard J. Barnet
164 Albert J. Bows
36 Alan R. Bromberg
156 Jack H. Calechman
308 Oliver O. Cromwell
30 Allan R. Curhan
374 Roger L. Davis
143 Nicholas T. DeLeoleos
120 Peter Elder
322 James S. Eustice
27 Ernest Getz
20 Isidore Goodman
153 Isidore Goodman
272 Donald H. Gordon
12 Richard L. Greene
68 Richard L. Greene
74 Leon Hariton
262 Leon Hariton
50 Harlan F. Harmsen
258 William H. Harrar
285 Richard G. Hewitt
34 W. Fletcher Hock
160 John B. Huffaker
84 Addis E. Hull III
337 Addis E. Hull III
66 Robert J. Kalupa
90 Charles A. Lippitz
54 Horace J. Littlefield
316 Martin Lore
146 Edward J. McGowen
361 Joseph M. Mero
294 John P. Miller
130 Jack Sidney Morris
160 I. Jerome O'Connor
354 Malcolm E. Osborn
301 John L. Palmer
102 William C. Penick
105 Joseph W. Price, 3rd
149 Alan Prigal
344 Frances B. Rapp
267 Raymond Rubin
141 John E. Scheifly
48 Paul D. Seghers
95 Paul D. Seghers
66 Richard K. Sell
114 Stanley C. Simon
136 Norman Sinrich
169 Walter A. Slowinski
183 Henry H. Steiner
172 William K. Stevens
180 Henry C. Stockell, Jr.
2 John E. Sullivan
130 Paul A. Teschner
348 David R. Tillinghast
186 Stanley P. Wagman
98 Charles M. Walker
138 Michael L. Weissman
156 Burton L. Williams
105 Bernard Wolfman
38 Paul D. Yager
180 Harry Yohlin

INDEX OF NEW DECISIONS REPORTED IN THIS ISSUE

NEW DECISIONS are listed below by the significant word or words in the citation, generally the taxpayer's last or principal name. The number is page where summary will be found.

Alexander 211
Almac's 208, 212
Amana Refrigeration 208
American Spring & Wire 211
Army Times Sales 229
Axe 240
L. S. Ayers and Co. 212
Bell 245
Bellah 245
Berner 211, 241
Bialock 210, 236
Bielawa 239
Blate 239
Bloomfield Steamship 212
Boe 213
Burnette 246
Burns 239
Cappola 246
Caswell 245
Century Indemnity 213
Chamber of Commerce of Kansas City 251
Coe Laboratories 229
Coldwater Cattle 213
Cole 245
Colin 210
Consolidated Gas and Equipment 207
Cooley 251
Copeland Estate 218
Coson 245
Crane Mills 208
Cranley 251
Curry 228
Diamond Estate 245
Dickerson 241
The Dill Co. 208
Dodd 211
Dunham 219
Eckert 246
Ellis Estate 219
Farwell 212, 213
Ferrer 207, 209
Field 245
Sanford H. E. Freund Estate 236
Gatling 244
Goldenberg Estate 250
Greystone Granite Quarries 207
Grubert 245
Guglielmetti 240, 244
Heebner 210
Herter 211, 212, 241, 251
Hogg 236
Holbrook 245
Holt 209
Honaker Drilling 229
Hoover 241
Hopkins 243
Hubner 218
Humphreys 251
Ingannamorte 244
Irving-Kolmar 229
Jantzer 254
Jones Estate 212, 221
Kalil 245
Kirsch 210
Kisting 221, 244
Krych 241
Kuckenberg 228, 244
Kuney 219
Kuntz Estate 246
LeVay 212
Linehan 210
Marshall 211
Marshman 240
Massagalia 239
Maximov 219
Mayer 218
McDonald 245
McLean 241
Miller 209, 236, 250
Monteleone 239
Moore 246
Moskowitz 244
Mountain State Steel 211
Murray 243
Oak Manufacturing 211
Oklahoma Natural Gas 212
Real Estate Corp. 207, 209
Reise 207
Reynolds 219
Riley 211
Roberson 221
Robinson's Dairy 208, 221
Rogers 210
Rolland 241
Russek Estate 209
St. Joseph Lead 245
Santos 239
Schowell 239
Schubert 213
Seagraves 221
Setze Estate 219
Silver 208
Spicknall 240
Starreis 208
Steele 213
Stephenson 238
Sweeney 246
Tenzer 244
Toierton & Warfield 244
Twining 229
Vernon 241
Vose 218
O. J. Wardwell Estate 251
Weiler 244
Weinfeld 241
Williams 208, 209, 238
Wincorn 211
Wollar 239

REVENUE RULINGS: The first number is that of the ruling, the second is the page number where a summary of the ruling will be found.

60-330 246
60-359 212
60-367 218, 251
60-375 212
60-377 213
60-378 240
60-379 246
60-384 251
60-386 213
60-390 213
61-1 240
61-5 240
61-7 211
61-11 246
61-18 210
Rev. Proc. 60-24 244
TD 6501 218
TIR 292 229

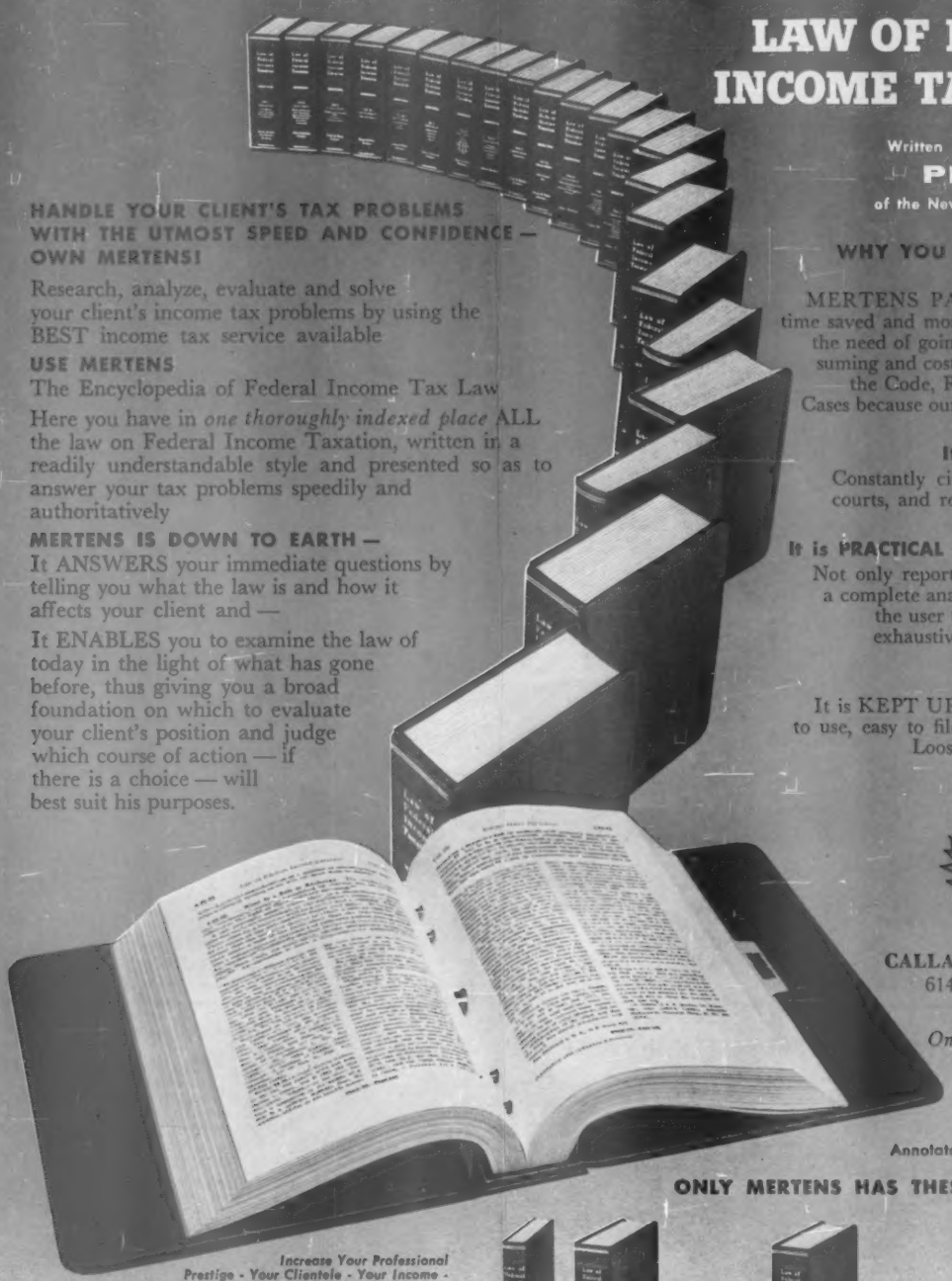
MERTENS

LAW OF FEDERAL INCOME TAXATION

Written by a Staff of Tax Experts

PHILIP ZIMET

of the New York Bar, Editor-in-Chief



HANDLE YOUR CLIENT'S TAX PROBLEMS WITH THE UTMOST SPEED AND CONFIDENCE — OWN MERTENS!

Research, analyze, evaluate and solve your client's income tax problems by using the BEST income tax service available

USE MERTENS

The Encyclopedia of Federal Income Tax Law

Here you have in *one thoroughly indexed place* ALL the law on Federal Income Taxation, written in a readily understandable style and presented so as to answer your tax problems speedily and authoritatively

MERTENS IS DOWN TO EARTH —

It ANSWERS your immediate questions by telling you what the law is and how it affects your client and —

It ENABLES you to examine the law of today in the light of what has gone before, thus giving you a broad foundation on which to evaluate your client's position and judge which course of action — if there is a choice — will best suit his purposes.

WHY YOU WILL PROFIT FROM OWNING MERTENS

MERTENS PAYS FOR ITSELF in time saved and money gained — eliminates the need of going through the time consuming and costly process of correlating the Code, Regulations, Rulings and Cases because our editors have correlated the material for you.

It is AUTHORITATIVE

Constantly cited and quoted by the courts, and relied on and referred to by government officials.

It is PRACTICAL and COMPREHENSIVE

Not only reports the law, but provides a complete analysis of it, thus enabling the user to take advantage of the exhaustive research of men with wide experience in this complex field.

It is KEPT UP TO DATE by an easy to use, easy to file and reasonably priced Loose-Leaf Upkeep Service.

Published by

CALLAGHAN & COMPANY

6141 North Cicero Avenue

Chicago 46, Illinois

One of the Nation's Oldest Law Book Publishers

Thoroughly Indexed and Cross Referenced, Fully Annotated, Kept Continuously to Date

ONLY MERTENS HAS THESE ADDED FEATURES

Two valuable books of the Mertens set are the 1954-58 CODE VOLUME (bound) and CODE VOLUME (Loose-leaf) 1959 to date. These volumes enable the MERTENS user to determine the exact wording of any section of the Code from the date of the enactment of the 1954 Code to date.

CODE COMMENTARY VOLUME. Provides a section by section analytical commentary of the Code showing the precise reasons for the changes brought about by the new Code and its amendments and indicating the importance of these changes in tax planning.

CURRENT TAX HIGHLIGHTS Spotlight the latest and most significant income tax developments. Published and mailed to Mertens subscribers at three-week intervals, they are keyed directly to Mertens and punched to fit the Code Commentary binder.

Increase Your Professional Prestige - Your Clientele - Your Income - Mail Coupon Today

JT-461

Callaghan & Company
6141 North Cicero Avenue
Chicago 46, Illinois

Date_____

Please send me details on how easily I can join the thousands of satisfied owners of **MERTENS LAW OF FEDERAL INCOME TAXATION**

Name_____
Print or Type Please

Address_____

City_____ Zone____ State_____